89-1613

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

R. RICHARD BASTIAN, III, B.P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR., and M.T. DAVISSON,

Petitioners,

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a Partnership,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MICHAEL H. MOIRANO
(Counsel of Record—
Application Pending)
NISEN & ELLIOTT
200 West Adams Street
Suite 2500
Chicago, Illinois 60606
(312) 346-7800

Counsel for Petitioners

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Midwest Law Printing Co., Chicago 60611, (312) 321-0220

QUESTIONS PRESENTED

1. Whether defrauded investors, in order to recover for violations of §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, must allege "loss causation", *i.e.*, that the defendants' fraudulent conduct directly caused a subsequent decline in the value of their investment.

2. Whether defrauded investors, in order to recover for violations of §1962 of the Racketeer Influenced and Corrupt Organizations Act, must allege facts showing that the defendants' fraud directly caused a subsequent decline in the value of their investment.

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The petitioners, R. Richard Bastian, III, B.P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CMF Associates, Alfred J. Hendron, Jr. and M.T. Davisson, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in this proceeding on January 9, 1990.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 892 F.2d 680 and is reprinted in the appendix hereto.

The opinions of the United States District Court for the Northern District of Illinois are reported at 681 F. Supp. 530 and 699 F. Supp. 161 and are also reprinted in the appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on January 9, 1990. This Petition for Certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. §78(j)(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> * * *

(b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the production of investors.

Section 1964(c) of the Racketeer Influenced and Corrupt Organizations Acts, 18 U.S.C. §1964(c):

Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any scheme, device or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances in which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Petitioners were investors in oil and gas drilling limited partnerships which were promoted by respondents Petren Resources Corporation, Faestel Investment, Inc. and David J. Faestel. Petitioners' investments in the partnerships were solicited by means of written offering memoranda prepared by a law firm representing the partnerships, respondent McDermott, Will & Emery.

The offering memoranda prepared and circulated by respondents were false and misleading in that they failed to disclose material information about the qualifications and experience of the promoters and, in some instances, flatly misrepresented facts about their net worth. Petitioners relied upon the accuracy of the statements made in the offering memorandum in making their investment decisions and were induced by the respondents' false statements to both purchase and hold their partnership interests. Petitioners were unaware of the respondents' fraud and by the time they discovered it, their investments were totally worthless.

Subsequent to the discovery of the fraud, petitioners filed suit in the United States District Court of the Northern District of Illinois seeking to rescind the transactions and recover the full amount paid for their investments. Petitioners alleged claims for violations of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78(j)(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5, and for violations of §1962 of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §1962. Jurisdiction of the district court was invoked under 28 U.S.C. §1331; 15 U.S.C. §78aa; and under 18 U.S.C. §1964.

Respondents never answered petitioners' complaint. Instead they moved to dismiss it pursuant to Fed. R. Civ. P. 12(b)(6). Conceding that petitioners had alleged a series of actionable violations of the federal securities laws, respondents contended petitioners were, nevertheless, not entitled to recover because they had failed to allege facts showing "loss causation," *i.e.*, that the defendants' fraudulent conduct actually caused a subsequent decline in their investment. The district court agreed with respondents' contentions and dismissed petitioners' complaint.

In the district court's initial memorandum opinion, entered March 7, 1987, the court held that "loss causation" was an essential element of an implied private right of action under §10(b) and Rule 10b-5. In order to satisfy the "loss causation" requirement, petitioners were required to plead and prove "that the information defendants allegedly omitted from the offering memoranda caused the decline in their . . . partnership interests". (App. 23).[1]

The district court also dismissed petitioners' RICO claim, but not due to a failure to allege "loss causation." Instead the court said that "loss causation" was a "judicially-imposed limitation" on the implied right of action under the securities laws "which simply did not apply to statutorily created RICO claims." (App. 26)[2]

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[1] The district court afforded petitioners the opportunity to amend their §10b and Rule 10b-5 claims to conform to the loss causation requirements, but the court warned that any such amendments which later proved to be incorrect "might be subject to sanctions." (App. 23)

[2] The district court dismissed petitioners' RICO claim because of a technical pleading deficiency relating to their "enterprise" allegations. (App. 28) Plaintiffs were given leave to file an amended complaint to cure this pleading defect.

Petitioners filed an amended complaint and corrected their RICO claim. However, because, as passive limited partner investors, petitioners had not had access to information which showed exactly what "caused the subsequent decline in their investment," they elected to forego, at least temporarily, further pursuit of their §10b and Rule 10b-5 claims, thus avoiding the district court's threat of sanctions.[3]

Respondents moved to dismiss petitioner's amended complaint pursuant to Fed. R. Civ. 12(b)(6), reasserting the "loss causation" arguments. While these motions were pending, they also successfully resisted petitioners' discovery efforts, convincing the district court that, pending a ruling, discovery should be restricted.

On October 28, 1988, the district court issued its second memorandum opinion in the case and dismissed petitioners' amended complaint. (App. 29) The court ruled that to recover under RICO a plaintiff must plead common-law "proximate causation" and that, in this case, where the predicate acts for the RICO violation involved repeated instances of securities fraud, proximate cause requires "an allegation that [the alleged] *omissions* lead to a decline in the value of the plaintiffs' investments." (App. 36) (emphasis in original). In other words, the court, contrary to its earlier decision, held that to prevail under RICO, petitioners had to also allege and prove "loss causation."

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[3] Plaintiffs had hoped that once they filed their amended complaint they would be permitted to engage in full-scale discovery which would have allowed them to determine precisely what happened to their investments but, as will be seen, this was not the case.

The Court of Appeals for the Seventh Circuit affirmed both rulings by the district court. (App. 1) Recognizing that "there is no controlling precedent in the Supreme Court or in this Circuit" and that "there are cases on both sides of the question in other circuits," the Seventh Circuit nevertheless elected to fully embrace "loss causation" as an essential pleading requirement applicable in all civil RICO and §10b and Rule 10b-5 cases. Characterizing "loss causation" as "the standard rule of tort law" (App. 7), the court justified its decision by suggesting that without the imposition of restrictive causation requirements, defrauded investors would be able to recover "windfalls," while defendants would become the "insurers" of unforseen calamities, subject to unlimited liability.

Applying the "loss causation" principles to the facts of this case, the Seventh Circuit said that petitioners should not recover because, even if the respondents "had come clean in their offering memoranda" and disclosed the truth about their experience and capabilities, petitioners would have invested in other similar oil and gas ventures which would have also failed as a result of the "collapse of oil prices in the early 1980's". Specifically the court said:

> Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national calamities. If the defendants' oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants' fraud and have no claim to damages.

(App. 7) The court thus concluded that "[I]f the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall." (App. 6)[4]

REASONS FOR GRANTING THE WRIT

1.

THE DECISION BELOW RAISES IMPORTANT QUESTIONS UNDER THE FEDERAL SECURITIES LAWS AND RICO WHICH HAVE NOT BEEN, BUT SHOULD BE, FINALLY SETTLED BY THIS COURT.

"Loss causation" has only recently been recognized by some courts as a separate element of a claim under §10b and Rule 10b-5. This case represents the first instance where a court of appeals has extended the "loss causa-

[4] Obviously, there is nothing in record to support the contention that if petitioners had been made aware of defendants' fraud they nevertheless would have readily invested in other oil and gas ventures. Moreover, the Seventh Circuit's suggestion that oil prices "collapsed" in the early 1980's and that this "caused" petitioners' loss is patently incorrect. Oil prices peaked in 1981 at $31.77 a barrel and gradually declined to $24.09 a barrel in 1985. The "collapse" in oil prices did not occur until 1986 when the price of oil dropped almost 50% to $12.50 a barrel. *See*, U.S. Dept. of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1989 at 677 (Tab. 1181). (App. 5) Petitioners discovered that they had been defrauded and that their investments were worthless in 1984, well before the "collapse" in oil prices and while drilling for oil was still a profitable venture. It was petitioners' dissatisfaction with the performance of their investments and their inability to obtain information from the respondents concerning the status of their investments which ultimately led to the discovery of the fraud.

tion" requirement to claims under RICO. This Court has never considered the propriety of "loss causation" in either context.

Imposing a strict "loss causation" pleading requirement will necessarily restrict the ability of injured parties to recover under §10b and RICO because it is often difficult for investors to make a pre-filing determination concerning the actual cause of the decline in the value of their investments. Many defrauded investors, like petitioners here, may be foreclosed from §10b and RICO remedies simply because they cannot allege, with the certainty required by Fed. R. Civ. P. 11, that the defendant's fraud directly caused their loss. This Court historically has not countenanced pleading or procedural barriers which restrict the remedies available under §10b or RICO. For this reason, this Court, in the exercise of its judicial discretion, should carefully consider the decision of the Seventh Circuit and issue a writ of certiorari to review and settle, once and for all, the causation questions the decision raises.

Loss Causation is only a recent addition to the legal lexicon. The concept of "loss causation" had its origin in the Second Circuit's opinion in *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374 (2d Cir. 1974) *cert. denied*, 421 U.S. 976 (1975). There the court said that where a 10b-5 claim is predicated solely upon material omissions or misstatements in proxy materials "there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question." *Id.* at 38 (emphasis in original) The Second Circuit did not explain why it was necessary to show both "loss causation" and "transaction causation," saying only that

loss causation "is demonstrated rather easily by proof of some form of economic damage." *Id.*

The subject of "loss causation" remained dormant for six years until 1980, when the Second Circuit again visited the subject in *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980). In *Marbury*, the court specifically rejected the notion that a defrauded investor had to plead and prove "loss causation" in order to recover under §10b. The court instead held that where an investor had been induced by fraud to invest, he would be entitled to recover his full loss regardless of whether the loss was attributable to the defendant's fraud.

There was a strong dissent filed in *Marbury*, however, which argued in favor of a strict application of a "loss causation" requirement. The *Marbury* majority responded to the dissent by warning that the adoption of any "new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in . . . would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction." *Id.* at 710, fn. 3.

Unfortunately, the *Marbury* dissent has gained greater favor in subsequent years and now, as a result, many courts, like the court below, deny recovery for fraudulently induced securities transactions where the fraud is not directly linked to a subsequent decline in the value of the underlying security. *See e.g., Huddleston v. Hermann & MacLean*, 640 F. 2d 534, 549-50, (5th Cir. 1981), *aff'd. in part on other grounds and rev'd. in part on other grounds*, 459 U.S. 375 (1983); *Bennett v. United States Trust Co.*,

770 F.2d 308, 313-14 (2d Cir. 1985); and *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1989).[5]

None of the courts which have adopted the "loss causation" requirement have considered, to any extent, whether the concept finds support in the language of the securities laws or the policies which underlie them. Instead, the majority of the courts, including the court below, have simply looked to common law tort concepts of causation and attempted to adapt them in the federal securities law context.

Efforts to shape the contours of the implied right of action under §10(b) with common law principles have often been criticized by this Court. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (holding that common-law doctrines of fraud which developed around transactions involving tangible items of wealth are ill-suited to the sale of intangibles such as securities.) In fact, this Court specifically criticized the Fifth Circuit's *Huddleston* decision for attempting to apply common law principles when analyzing the appropriate standard of proof in §10(b) actions:

> "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable". Moreover, the anti-fraud provisions of the securities laws are not coextensive with common law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing

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[5] The Fifth Circuit's 1981 decision in *Huddleston* was the first court of appeals decision subsequent to *Schlick* to recognize the "loss causation" requirement.

> higher standards of conduct in the securities industry. *See, SEC v. Capital Gains Research Bureau, Inc., supra*, 375 U.S., at 186, 84 S.Ct., at 279.

Id. at 308.

More recently, in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), the Court re-emphasized that Congress' aim in the 1934 Act was "not confined solely to compensating defrauded investors," but that Congress also "intended to deter fraud." *Id.* at 644. The Court recognized that this deterrent purpose would be "ill-served by too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss'." *Id.* Indeed, *Randall* acknowledged, in *dictum*, that imposing liability on defendants for all losses caused by fraud would only serve to advance §10b's deterrent intent. *Id.* at 661.

Despite this Court's guidance, the courts of appeals which have adopted the "loss causation" requirement have done so without any real analysis of whether application of a strict causation requirement would further Congress' intent. Instead, these courts have mechanically applied common law tort principles, ignoring the fact that the implied action under §10b was intended to supplant and expand common law remedies.

Imposing strict causation requirements only serves to compromise the deterrent purpose of the securities laws, allowing some defendants to escape liability altogether because the defrauded plaintiffs cannot satisfy the causation test. For example, in the Fifth Circuit's decision in *Huddleston*, the plaintiffs proved without doubt that the defendants used false and misleading financial statements to induce them to purchase securities. Yet, the Fifth Circuit said that the plaintiffs would not be entitled to recover if the defendants could show that the failure of the in-

vestment was due to other causes, such as "bad weather." Here there is no question respondents used a false and misleading offering memorandum to solicit the petitioners, yet the petitioners have been denied the opportunity to obtain any recovery because they did not have sufficient facts available to them to allege with the certainty required by Fed. R. Civ. P. 11 that the respondents fraudulent conduct directly caused a subsequent decline in the value of their investments.[6]

It is not surprising that in the wake of *Huddleston* and its progeny, "loss causation" has become the darling of securities fraud defendants. What the loss causation decisions tells these defendants is that even though they have committed fraud, they have a good chance of escaping or limiting their liability by persuading a judge or jury that there was, or reasonably could be, another "cause" for the decline in the value of the investment.

For example, under the loss causation analysis, any defendant who fraudulently induced investors to purchase publicly traded stock shortly before the stock market crashes of 1929, 1987 or 1989, should be able to easily avoid liability by claiming that the investors' losses were not caused by their fraud, but resulted from the market collapse. Similarly, under the Seventh Circuit's analysis, all investors who were fraudulently induced to invest in oil and gas ventures in the early 1980's would be precluded from any recovery because it can be assumed that

[6] In its opinion, the Seventh Circuit suggested that petitioners could have satisfied Rule 11 by determining that other oil and gas ventures managed by competent and honest personnel profited while petitioners' venture failed. But the court fails to explain how proof of the success of other ventures establishes why petitioners' venture failed.

they would have invested in oil and gas even absent any fraud and thus would have lost their investment anyway when the price of oil collapsed.

"Loss causation" not only limits an investor's ability to recover and enhances defendant's chances of escaping liability, it also undercuts the policy of full disclosure which underpins the securities laws. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988). For example, in cases like this, there would be little motivation for a promoter to be candid about collateral but material matters not directly related to the value of the security because he knows that an investor could have a difficult time alleging and proving that the concealed collateral facts directly caused a subsequent decline in the security's value. Because loss causation significantly reduces a defendant's potential exposure to liability, upholding the causation requirement is likely to encourage rather than discourage the withholding of material adverse facts.

The courts which have embraced "loss causation" have not only ignored the negative impact the causation requirement will have on the important policy considerations underlying §10b and Rule 10b-5, they have also not considered relevant decisions by this Court which directly address the causation question. For example, in *Mills v. Electric Auto-Lite*, 396 U.S. 375 (1970), the Court was asked to decide whether an implied cause of action for violations of §14(a) of the 1934 Act (relating to fraudulent or misleading proxy solicitations) could be sustained without a showing of a direct causal link between the defect in the proxy statement and the outcome of the voting. The Court analyzed the question in terms of materiality and concluded that where the misstatement or omission in the proxy statement was shown to be material,

a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress. The Court specifically rejected the notion that in order to prevail, an aggrieved shareholder also had to allege and prove a direct causal link between the misstatement or omission and the outcome of the vote. *Id.* at 385-87.

A similar test of causation was adopted by the Court in the context of implied actions under §10(b). In *Affiliated Ute v. United States*, 406 U.S. 128, 152 (1972), the Court held that in an omissions case brought under §10(b) causation in fact was established by showing that a material fact which may have impacted an investment decision was intentionally withheld by a person having a duty to disclose. The Court imposed no separate requirement that the withheld fact also "cause" a subsequent decline in the investment. The Court simply held that where the withholding of a material fact is shown an investor is entitled to recover.

The amount a defrauded investor should recover raises a separate question. In *Mills*, this Court interpreted §29(b) of the Exchange Act as rendering any contract made in violation of the Act or any rule thereunder voidable and subject to rescission at the option of the innocent party. *Id.* at 387-88.[7] Similarly, in *Randall*, the Court recognized, without explicitly deciding, that rescission or a rescissory

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[7] Section 29(b), 15 U.S.C. §78cc(b), provides in pertinent part:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made . . . any such contract. . .

measure of damages may sometimes be appropriate under §10b. *Id.* 478 U.S. at 662.[8]

Assuming, arguendo, that rescission is an available remedy for violations of §10b or Rule 10b-5, the question of "loss causation" becomes totally irrelevant because the victim of the fraud is able to obtain full restitution of the purchase price upon tender of the security. This is true regardless of whether there has been any decline in the value of the security caused by the defendant's fraud. *Randall*, 478 U.S. at 659.

Even assuming rescission is not available as a remedy, defrauded investors need not establish "loss causation" in order to recover. In *Affiliated Ute*, this Court recognized that a defrauded investor may recover damages where the defendant realizes a profit that exceeds any actual loss the investor sustained. *Id.* 406 U.S. at 156. As this Court explained in *Randall*, requiring securities fraud defendants to disgorge ill-gotten profits adds an additional measure of deterrence:

> This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan v. Taylor*, 344 F.2d 781, 786 (CA1) *cert. denied*, 382 U.S. 879, 15 L. Ed. 2d 120, 86 S.Ct. 163

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[8] Even under common law principles, a party who is fraudulently induced to enter into a transaction has the right to rescind the transaction and recover his full consideration. *See*, Restatement (Second) of Restitution §28 (1977); Restatement (Second) of Contracts §164 (1979).

(1965). See also *Falk v. Hoffman*, 233 N.Y. 199, 135 N.E. 243 (1922).

478 U.S. at 663.

Finally, even under a stricter compensatory measure of damage, a defrauded investor is at least entitled to recover "the difference between the fair value of all the [investor] received and the fair value of what he would have received had there been no fraudulent conduct." *Affiliated Ute*, 406 U.S. at 156. In this case, there is no question that petitioners did not receive the investment they bargained for.

Petitioners were told they were investing in an oil and gas venture being managed by able and experienced industry experts. In fact, the promoters were incompetent, inexperienced, had been sued in connection with prior ventures and were on the verge of financial collapse. There can be little doubt that an oil and gas venture which is being managed by incompetents does not have the same value to an investor as one being managed by an experienced and capable staff. The risks involved in poorly managed venture far exceed the risks involved in a well managed one. To suggest under the circumstances of this case, where petitioners were induced by fraud to commit their capital to a venture that involved greater risk than had been represented, they suffered no compensable loss, simply ignores the realities of the transaction.

Under the "loss causation" analysis adopted by the Seventh Circuit defrauded investors are not only precluded from recovering the kind of compensatory damages contemplated in *Affiliated Ute*, they are also not allowed to obtain rescission or rescissory damages, or to seek disgorgement of the defendant's profits. Instead, the investors' recovery is strictly limited to an amount meas-

ured by any decline in the value of the security directly caused by the defendant's fraud. If the investor cannot allege and prove such specific injury, there is no recovery and the defendant is absolved of any liability and allowed to retain all the benefits derived from the fraud.

The justification for this kind of a result apparently arises out of a concern for imposing unwarranted liability on fraud defendants. As the dissent put it in *Marbury*, the concern is that without a strict loss causation requirement the perpetrator of the securities fraud would "become an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock." *Id.* 629 F.2d at 718. This same sentiment was expressed by the Fifth Circuit in *Huddleston*, 640 F.2d at 549, and it was expressed by the Seventh Circuit and the district court in this case. (App. 7, 23)

But in expressing their concern for the protection of securities fraud defendants, these courts overlook two important facts. First, the defendant only becomes the "insurer" of the investment if it can be shown that, in connection with the purchase or sale of the security, he acted with scienter, *i.e.*, a specific intent to defraud. It is unclear why anyone should be concerned about protecting the rights and liabilities of persons who have been proven to have engaged in intentional fraud. Second, the securities fraud defendant can easily avoid becoming an "insurer" of an investment by complying with the disclosure requirements of the securities laws. When the defendant knowingly elects to ignore those requirements and proceeds to fraudulently induce innocent parties to invest, there is no good reason why he should not be compelled to "insure" the victims of his acts.

That is not to say that in all cases a defendants' liability is unlimited. A defendant should not be compelled to bear the consequences of a risk which the investor would otherwise have accepted. Thus, in this case, if the defendants can show that the petitioners would have assumed the risk of the venture, even if the truth about their qualifications and experience were known, then there would be no recovery. Similarly, a defendant should not be held responsible for any loss which occurs after the fraudulent conduct is disclosed. But while an investor remains the unwitting victim of the defendants' fraud, any loss that the investor sustains should be the responsibility of the defendant. To permit otherwise would defeat and not effectuate, the purpose of the securities laws and encourage, not deter, securities fraud.

The same rationale applies under RICO. In affirming the dismissal of petitioners' civil RICO claim, the Seventh Circuit applied the principles of "loss causation" calling it "just an exotic name for a standard requirement of tort law." (App. 7) But imposition of this "standard requirement of tort law" is inconsistent both with this Court's decisions under RICO and the deterrent policies the Act was intended to implement.

The express civil remedy set forth in RICO does not require that a party seeking relief plead "loss causation" or "proximate causation." All RICO requires is that the party be injured in his business or property "by reason of" a RICO violation.[9] Whether this language requires

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[9] Specifically, Section 1964(c), 18 U.S.C. §1964(c), provides:

> Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

"loss causation" or "proximate cause" or some lesser causal connection is a matter of statutory construction.

This Court has said that in identifying the limits of an explicit statutory remedy, legislative intent is the controlling consideration. *Blue Shield of Virginia v. McCready*, 467 U.S. 465, 477 n. 13 (1982), citing *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 377-78 (1982). While Congress never directed its attention specifically to RICO's "by reason of language," much has been written about the legislative intent.[10] Most significant is the often cited admonition that RICO is to "be liberally construed to effectuate its remedial purposes." Pub. L. 91-452, §904(a), 84 Stat. 947.

In *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498 (1985), this Court said that RICO's " 'remedial purposes' are nowhere more evident than in the provision of a private action for those injured by racketeering activity." The Court cautioned that narrow interpretations of the private remedy would only serve to defeat the Act's remedial intent. *Id.* The Court supported its conclusion by pointing out that a previous proposal to simply add RICO-like provisions to the Sherman Act was rejected precisely because it "could create inappropriate and unnecessary obstacles in the way of . . . a private litigant [who] would have to contend with a body of precedent—appropriate in a purely antitrust context—setting strict requirements on questions such as 'standing to sue' and 'proximate cause'." 115 Cong. Rec. 6995 (1969) (ABA comments on S. 2048).

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[10] *See* Organized Crime Control Act of 1970, H.Rep. No. 91-1549, 91st Cong., 2d Sess. (Sept. 30, 1970); 116 Cong. Rec. 35191-217 (Oct. 6, 1970); *Id.* at 35287-364 (Oct. 7, 1970); *Id.* at 36281-96 (Oct. 12, 1970); *Id.* at 35201; *Id.* at 35196-97, 35200; *Id.* at 36294, 36296.

In this case, by imposing a strict "proximate cause" or "loss causation" requirement on private remedies under RICO, the Seventh Circuit created the exact problem Congress sought to avoid. The court limited the private remedy using common law principles inappropriate in this context. The Act requires only that there be an injury "by reason of" a RICO violation. This requirement should be broadly construed to effectuate the Act's remedial purpose.

2.

THERE IS CONFUSION AND CONFLICT BETWEEN AND WITHIN THE CIRCUITS REGARDING LOSS CAUSATION.

Both the Seventh Circuit and district court recognized in their decisions below that there is confusion and conflicts concerning the causation requirement in §10b and Rule 10b-5 actions. (App. 8, 17-18) This confusion and conflict even exists within in the Seventh Circuit.

In an earlier decision, the Seventh Circuit, in *dictum*, expressly criticized the "loss causation/transaction causation" analysis stating, "[T]hese terms, ungainly to start with because they constrict nouns for service as adjectives, have been confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws." *LHLC Corp. v. Cluett Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 109 S.Ct. 311 (1988). The Court explained that when analyzing causation under the securities laws the focus should be on "whether the information disclosed or withheld affected an investment decision." *Id.*

Subsequently, in *Rankow v. First Chicago Corporation*, 870 F.2d 356 (7th Cir. 1989), the Seventh Circuit seemingly rejected the very same loss causation theory adopted by the court in this case. In *Rankow*, the Seventh Circuit held:

> The theory of loss causation advanced by [the defendant] and accepted by the district court is a good example of this confusion. Under the district court's theory, any intervening change in market conditions not directly caused by the defendant could break the chain of causation and exempt the defendant from liability, a result that would eviscerate Rule 10b-5.

Id. at 367. Although the court in *Rankow* did not totally abandon the loss causation analysis, it did hold that under its view of the loss causation, the loss causation requirement could be met "rather easily by proof of some form of economic damage." *Id. citing Schlick*, 507 F.2d at 380.

The Second Circuit has also issued a number of seemingly conflicting opinions which have only added to the confusion concerning loss causation. Compare *Manufacturers Hanover Trust Company v. Drysdale Securities Corporation*, 801 F.2d 13 (2nd Cir. 1986), *cert. denied*, 107 S.Ct. 952 (1987) (reaffirming the *Marbury* majority analysis) with *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2nd Cir. 1986), *cert. denied*, 106 S.Ct. 800 (1987) (requiring a strict showing of both "loss causation" and "transaction causation").

The Fifth Circuit too has undercut a strict application of the loss causation requirement where, as in this case, it is alleged that absent the defendants' fraud, the securities would have been unmarketable. *Shores v. Sklar*, 647 F.2d 462, 470 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983).

Other courts, apparently trying to reconcile *Huddleston* with the majority opinion in *Marbury*, have created exceptions to the loss causation requirement where brokers, privities or fiduciaries are involved. *See, e.g., Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984); *In re Letterman Bros. Energy Securities Litigation*, 799

F.2d 967, 972 (5th Cir. 1986), *cert. denied*, 197 S.Ct. 1373 (1987).

Finally, the Eleventh Circuit recently recognized an exception to a strict application of the "loss causation" requirement "when a defendant misrepresents a stock's intrinsic worth at the time of the representation." *Bruschi v. Brown*, 876 F.2d 1526, 1531 (11th Cir. 1989)

Causation is no doubt a troublesome concept and the lower courts have had difficulty grappling with its application in the §10b and RICO contexts. What has evolved is a series of conflicting and inconsistent decisions which have caused confusion and concern for the courts and investors alike. Because of the confusion, there is a compelling need for this Court, at this juncture, to examine the causation question and provide the lower courts with some direction. This case affords the Court the opportunity to do just that.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Seventh Circuit.

Respectfully submitted,

MICHAEL H. MOIRANO
(Counsel of Record—
Application Pending)
NISEN & ELLIOTT
200 West Adams Street
Suite 2500
Chicago, Illinois 60606
(312) 346-7800

Counsel for Petitioners

APPENDICES

APPENDIX 1

892 F.2d 680 (1990)

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 88-3299

R. RICHARD BASTIAN, III, *et al.*,

Plaintiffs-Appellants,

v.

PETREN RESOURCES CORPORATION, *et al.*,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 86 C 2006—**Brian Barnett Duff**, *Judge*.

ARGUED OCTOBER 25, 1989—DECIDED JANUARY 9, 1990

Before BAUER, *Chief Judge*, POSNER, *Circuit Judge*, and ESCHBACH, *Senior Circuit Judge*.

POSNER, *Circuit Judge*. In 1981 the plaintiffs invested $600,000 in oil and gas limited partnerships promoted by the defendants. The plaintiffs allege that, had it not been for the offering memoranda's misrepresentations and misleading omissions concerning the defendants' competence and integrity, the plaintiffs would not have invested in these partnerships, which by 1984 were worthless. The original complaint charged violations of Rule 10b-5 of the

Securities and Exchange Commission, and the RICO statute (18 U.S.C. §§ 1961 *et seq.*), and sought damages equal to the investment. The district judge dismissed this complaint, but without prejudice, on the defendants' motion under Fed. R. Civ. P. 12(b)(6) to dismiss for failure to state a claim. 681 F. Supp. 539 (N.D. Ill. 1988). With respect to the RICO charge he found only a minor technical deficiency easily curable by filing an amended complaint. With respect to the Rule 10b-5 charge he found a more serious deficiency: a failure to allege "loss causation"—that is, that if the facts had been as represented by the defendants the value of the limited partnerships would not have declined. This deficiency, too, was potentially curable by an amendment to the complaint, but the judge warned the plaintiffs that if they alleged but later failed to prove loss causation he might impose sanctions on them under Fed. R. Civ. P. 11.

The plaintiffs filed an amended complaint, curing the RICO oversight, but they did not reallege a violation of Rule 10b-5. The district judge dismissed the amended complaint on the ground that proximate cause in a RICO case requires, much as in a Rule 10b-5 case, that the facts concealed or distorted were responsible for the decline in the value of the limited partnerships. The amended complaint contained no such allegation, no doubt for the same reason the plaintiffs had not amended their Rule 10b-5 count: they did not think they could prove loss causation. The dismissal this time was with prejudice, and so terminated the suit and set the stage for this appeal.

The defendants argue that having failed to include the Rule 10b-5 charge in the amended complaint, the plaintiffs have waived any challenge to the district judge's dismissal of that charge in the original complaint. We disagree. That dismissal was not an appealable order, because the dismissal of a complaint with leave to amend is not a final decision. *Harris v. Milwaukee County Circuit Court*, 886 F.2d 982, 984 (7th Cir. 1989); 28 U.S.C. § 1291. There was no appealable order until Judge Duff dismissed the amended complaint with prejudice. When a final decision is appealed, the appeal brings up all previous

rulings of the district judge adverse to the appellant. *Asset Allocation & Management Co. v. Western Employers Ins. Co.*, No. 89-1686, slip op. at 3 (7th Cir. Dec. 26, 1989); *Disher v. Information Resources, Inc.*, 873 F.2d 136, 140-41 (7th Cir. 1989). Otherwise there would be no way to obtain appellate review of those rulings, save for the exceptional few that were appealable regardless of finality.

It is not waiver—it is prudence and economy—for parties not to reassert a position that the trial judge has rejected. Had the plaintiffs repleaded their Rule 10b-5 charge without alleging loss causation, the judge would have dismissed the charge, not only with prejudice but with annoyance. If they had alleged loss causation, they would have abandoned their principal disagreement with Judge Duff, which is over whether such an allegation is necessary, and would indeed have exposed themselves to sanctions if, as we suspect, they have no evidence of loss causation. For if they had had sufficient evidence to satisfy Rule 11's requirement of a reasonable precomplaint inquiry, they would have amended their complaint, while reserving for appeal (should they lose in the district court) their contention that proof of loss causation is inessential.

The case is no different from one in which a district judge grants partial summary judgment for the defendant, dismissing one of the plaintiff's claims, and after a trial dismisses the rest of the claims. Except as permitted by Fed. R. Civ. P. 54(b), the plaintiff cannot appeal until all his claims have been dismissed, but when he does appeal he can bring up the grant of partial summary judgment. He need not request the district court to reexamine its earlier rulings.

We come to the merits. The plaintiffs argue that they should not be required to allege that, but for the circumstances that the fraud concealed, the investment that they were induced by the fraud to make would not have lost its value. They say it should be enough to allege that they would not have invested but for the fraud; for if they had not invested, they would not have lost their money, and the fraud was therefore the cause of their loss. They say

they have no idea why their investment was wiped out and it does not matter; the defendants, being responsible for the disaster by having used fraud to induce the investment, must not be allowed to get off scot-free just because the plaintiffs do not know how the investment would have fared in the marketplace had the facts about the defendants' competence and integrity been as represented. As a fallback position the plaintiffs argue that the defendants should have the burden of proving what part (if any) of the loss would have occurred even if the defendants had been as competent and honest as represented.

Rule 10b-5 is not a complete scheme for remedying securities fraud. Indeed, it is just a declaration that securities fraud is unlawful. The right to bring a private action for damages that the rule has been held to confer is an implied right, *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n. 9 (1971), and its dimensions and incidents are a common law growth nourished by analogies from the law of torts. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-49 (1975); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 97 (10th Cir. 1971); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966) (Eschbach, J.); cf. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192-95 (1963). All Rule 10b-5 does is supply the foundation upon which federal judges have built a federal common law of securities fraud. *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985). It would be surprising therefore if the rules that have evolved over many years to establish the contours of common law actions for fraud and other intentional torts were entirely inapplicable to suits under Rule 10b-5, and of course they are not. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Indeed what securities lawyers call "loss causation" *is* the standard common law fraud rule (on which see Prosser and Keeton on the Law of Torts § 110, at p. 767 (5th ed. 1984)), merely borrowed for use in federal securities fraud cases. It is more fundamental still; it is an instance

of the common law's universal requirement that the tort plaintiff prove causation. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982). No hurt, no tort. *Heil v. Morrison Knudsen Corp.*, 863 F.2d 546, 550 (7th Cir. 1988). Forget fraud for a moment and consider a standard medical malpractice case. The plaintiff's decedent goes to the defendant for medical treatment, receives incompetent treatment, dies. The plaintiff must allege that, had it not been for the incompetent treatment, his decedent would have lived (or lived longer). It is no answer that the plaintiff cannot be expected to know *why* his decedent died; it is his burden to gather enough information on the matter in advance of filing suit to comply (if the suit is in federal court) with Rule 11's requirement of a reasonable precomplaint inquiry. Even if the defendant in our hypothetical malpractice case had been a veterinarian passing himself off as a physician, the plaintiff would have to show that the defendant had failed to meet the standard of care of a physician. Prosser and Keeton on the Law of Torts, *supra*, § 36, at p. 226.

The plaintiffs alleged that they invested in the defendants' limited partnerships because of the defendants' misrepresentations, and that their investment was wiped out. But they suggest no reason *why* the investment was wiped out. They have alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction's turning out to be a losing one. It happens that 1981 was a peak year for oil prices and that those prices declined steady in the succeeding years. U.S. Dept. of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1989, at 677 (tab. 1181). When this happened the profitability of drilling for oil (and gas, which generally is produced with it) in the continental United States plummeted. The costs of obtaining oil and gas from our depleted reservoirs are far higher than the costs in other regions, and drilling for oil and gas is therefore profitable only in times when prices are very high. Suppose that because of the unexpected drop in oil prices after 1981, all or the vast majority of the oil and

gas limited partnerships formed in 1981 became worthless. Then it would be highly unlikely that the plaintiffs' loss was due to the defendants' fraud. If the defendants had come clean in their offering memoranda, then we may assume—because the plaintiffs allege, and the case was dismissed on the complaint—that the plaintiffs would not have invested in the defendants' limited partnerships. But there were plenty of other oil and gas limited partnerships they could have invested in. They wanted to invest in oil and gas limited partnerships; they only wanted to be sure that the general partners were honest and competent people. Yet to be honest and competent is not to be gifted with prevision. If the alternative oil and gas limited partnerships to which these plaintiffs would have turned had the defendants leveled with them were also doomed, despite competent and honest management, to become worthless, the plaintiffs were not hurt by the fraud; it affected the place but not the time or amount of their loss.

To satisfy Rule 11 all that the plaintiffs had to do was to obtain evidence from persons knowledgeable about oil and gas ventures in the early 1980s that many or most oil and gas ventures had succeeded notwithstanding the downturn in price after 1981. Perhaps if the plaintiffs had conducted such a search they would have discovered, contrary to our speculation (and it is just that), that oil and gas ventures managed by competent and honest businessmen *had* survived the drop in oil prices. If so, this would support an inference that if the defendants had been as competent and honest as they represented themselves to be, they would not have lost the plaintiffs' $600,000. The plaintiffs' unwillingness to make this allegation in their amended complaint suggests to us that they may have made inquiry of experts in the oil and gas industry and discovered that the cause of the disaster was unrelated to the competence and honesty of the defendants.

If the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall. Other sections of the securities laws, such as section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*, permit

windfall recoveries, but we do not see how this helps the plaintiffs. Those sections deal with other conduct and some of them contain restrictions on liability that Rule 10b-5 does not. See, e.g., 15 U.S.C. § 77m; *Wilson v. Ruffa & Hanover, P.C.*, 844 F.2d 81, 84 (2d Cir. 1988). And proof of loss causation has been held to be required in some actions under section 12(2), *Wilson v. Ruffa & Hanover, P.C., supra*, 844 F.2d at 85-86, while in actions under section 11 of the 1933 Act, 15 U.S.C. § 77k, absence of loss causation is an explicit defense. Rule 10b-5 has been interpreted to authorize the creation of a federal common law of securities fraud, and common law fraud is not actionable without proof of harm. No reason is given why Rule 10b-5 should be an exception to this principle.

"Loss causation" is an exotic name—perhaps an unhappy one, *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir. 1988)—for the standard rule of tort law that the plaintiff must allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains. Like a stock-market crash, the collapse of oil prices in the early 1980s reverberated throughout the economy. Since the United States is a net importer of oil, the reverberations were for the most part good ones. But there were some losers. No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities. If the defendants' oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures, lost nothing by reason of the defendants' fraud and have no claim to damages. *Sims v. Faestel*, 638 F. Supp. 1281 (E.D. Pa. 1986), aff'd without opinion, 813 F.2d 399 (3d Cir. 1987).

We have treated the question whether loss causation is an element of a claim for damages under Rule 10b-5 from the ground up because there is no controlling precedent in the Supreme Court or in this circuit, and because there are cases on both sides of the question in the other circuits, though they greatly preponderate in favor of the requirement and such conflict as there is appears to be within rather than among circuits. Compare *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir., 1974); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549-50 (5th Cir.), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1983); *Bennett v. United States Trust Co.*, 770 F.2d 308, 313-14 (2d Cir. 1985), and *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988), with *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 708-10 (2d Cir. 1980), and *Bruschi v. Brown*, 876 F.2d 1526, 1530-31 (11th Cir. 1989). Our cases either state in dictum, or assume, that the requirement does exist. *LHLC Corp. v. Cluett, Peabody & Corp., supra*, 842 F.2d at 931; *Kademian v. Ladish Co.*, 792 F.2d 614, 628 n. 11 (7th Cir. 1986); *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775, 779 (7th Cir. 1988); *Rankow v. First Chicago Corp.*, 870 F.2d 356, 367 (7th Cir. 1989). We have tried to explain why it should exist, and now we add a note on its scope which suggests that some of the cases that express disagreement with the doctrine may be reconcilable with it. Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case (well illustrated by *Bruschi v. Brown, supra*, 876 F.2d at 1527) is therefore consistent with nonliability in a case such as the present. The plaintiffs in the present case were not told that oil and gas partnerships are risk-free. They knew they were assuming a risk that oil prices might drop unexpectedly.

They are unwilling to try to prove that anything beyond the materializing of that risk caused their loss.

Because "loss causation" is just an exotic name for a standard requirement of tort law, Judge Duff was also correct to dismiss the amended complaint. Cf. *Currie v. Cayman Resources Corp., supra*, 835 F.2d at 785-86. The plaintiffs would not allege that the defendants' violations of the RICO statute caused the investment loss that the plaintiffs seek by this lawsuit to recoup. A civil RICO suit requires pleading and proof of loss "by reason of" the defendant's violation. 18 U.S.C. § 1964(c). This means cause. *Haroco v. American National Bank & Trust Co.*, 747 F.2d 384, 398 (7th Cir. 1984), aff'd per curiam, 473 U.S. 606 (1985); *Sperber v. Boesky*, 849 F.2d 60, 64 (2d Cir. 1988); *Brandenburg v. Seidel*, 859 F.2d 1179, 1187 (4th Cir. 1988). If the plaintiffs would have lost their shirts in the oil and gas business regardless of the defendants' violations of RICO, they have incurred no loss for which RICO provides a remedy.

The cases go further, by requiring not only cause but also "proximate cause." *Brandenburg v. Seidel, supra*, 859 F.2d at 1189; *Zervas v. Faulkner*, 861 F.2d 823, 834-35 (5th Cir. 1988). This unfortunate bit of legal jargon is used to cut off liability, for a variety of special reasons, for harms caused by the defendant's conduct in the ordinary-language sense of "caused." Cf. *Rardin v. T & D Machine Handling, Inc.*, No. 89-1271 (7th Cir. Nov. 21, 1989). We need not explore the nature of these grounds in the RICO setting, a subject canvassed in the *Zervas* and *Brandenburg* cases as well as in our own *Marshall & Ilsley Trust Co. v. Pate*, 819 F.2d 806 (7th Cir. 1987). Some cases describe the requirement of showing loss causation in Rule 10b-5 as an element of proximate cause (*Currie v. Cayman Resources Corp., supra*, 835 F.2d at 785, for example), but we think it more accurately described as an element of cause, period. For if it is not established, the trier of fact can have no confidence that the plaintiff would be better off if the defendant had refrained from the unlawful act.

AFFIRMED.

JUDGMENT – ORAL ARGUMENT

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

January 9, 1990.

Before

Hon. WILLIAM J. BAUER, *Chief Judge*
Hon. RICHARD A. POSNER, *Circuit Judge*
Hon. JESSE E. ESCHBACH, *Senior Circuit Judge*

R. RICHARD BASTIAN, III, et al.,

Plaintiffs-Appellants,

No. 88-3299 vs.

PETREN RESOURCES CORPORATION, et al.,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 86 C 2006—**Brian Barnett Duff**, *Judge*

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

APPENDIX 2

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681 F.Supp. 530 (N.D. Ill. 1988)

R. Richard BASTIAN, III, et al., Plaintiffs,

v.

PETREN RESOURCES CORPORATION, et al., Defendants.

No. 86 C 2006.

United States District Court, N.D. Illinois, E.D.

March 7, 1988.

* * * * *

MEMORANDUM OPINION

BRIAN BARNETT DUFF, District Judge.

This case arises out of the sales of limited partnership interests in two Illinois oil and gas limited partnerships, Petren 1981A and Petren 1981B. Each plaintiff is a limited partner of one or both of these partnerships. The complaint alleges that defendants—the general partners of the partnerships along with their attorneys—violated federal securities laws as well as state statutes and common law, and engaged in a pattern of racketeering activity, through various material non-disclosures they made prior to the sales of the partnership interests. Defendants have moved to dismiss all seven counts of the complaint on the grounds that plaintiffs have failed to state a claim upon which relief may be granted in any of the counts. This court has jurisdiction pursuant to 28 U.S.C. § 1331. For the reasons set forth below, the motion to dismiss the complaint is granted.

FACTS

The complaint names corporate defendants, Petren Resources Corporation ("PRC") and Faestel Investments ("FI"), as co-general partners in the limited partnerships, individual defendant David J. Faestel ("Faestel"), as the officer, director and sole shareholder of FI and the Chairman of the Board and principal shareholder of PRC, the law firm McDermott, Will and Emery ("MWE"), as legal representative of Faestel and FI, and Brian S. Hucker, as a lawyer with MWE. According to the complaint, at some time in 1981 MWE and Hucker prepared "Offering Memoranda" for the two limited partnerships in order to solicit and sell partnership interests. The Offering Memoranda described the limited partnerships Petren 1981A and 1981B as oil and gas ventures, identified FI and Petren as co-general partners in the partnerships and named MWE as counsel for the partnerships. It also described Faestel, FI and Petren as "being qualified and experienced in oil and gas ventures," and "purport[ed] to disclose all material information about the limited partnerships, including information about the two general partners and their principals."

Plaintiffs claim that, after receiving and reading the Offering Memoranda, they each decided to, and did invest in one or both of the limited partnerships. They assert, however, that they would not have invested had the Offering Memoranda not knowingly "failed to disclose the following facts about the qualifications and prior experience of Faestel, FI and Petren:"

> (a) That in or about September, 1979, Faestel and [FI] were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and [FI] had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior oil and gas ventures they had promoted; and

(c) That Petren was established by Faestel and [FI] solely to promote the Petren Oil and Gas Programs and that Petren was, in actuality, nothing more than the alter ego of Faestel and [FI].

The complaint further alleges that MWE and Hucker had represented Faestel and FI in the (non-disclosed) securities litigation and loan transactions, that all of the defendants knew about these problems at the time the Offering Memoranda were prepared and distributed, and that plaintiffs did not know of these problems at the time they purchased their partnership interests. Indeed, according to the complaint, plaintiffs only learned of them when, in 1984, plaintiff Ronald Rotunda became concerned about his investment in Petren 1981B and hired an attorney to investigate the limited partnerships.

Plaintiffs claim that, during the investigation Hucker told Rotunda's attorney that Rotunda was the only limited partner questioning the conduct of Faestel or the general partners, but that, in fact, "at the time Rotunda's attorney was conducting the investigation, there were at least two separate federal actions filed against Faestel and the general partners relating to the Petren Oil and Gas Programs." In any case, plaintiffs allege, by the time Rotunda's attorney had completed his investigation, "plaintiffs' investments in the Petren Oil and Gas Programs had become worthless."

Plaintiffs filed the instant lawsuit in March, 1986, alleging private rights of action under the following criminal statutes: Count I—§ 10(b) of the Securities and Exchange

Act of 1934, 15 U.S.C. § 78j(b) ("§ 10(b)") and Securities and Exchange Commission Rule 10b-5 ("Rule 10b-5"), 17 C.F.R. § 240.10-5; Count II—§ 17(a) of the Securities and Exchange Act of 1933, 15 U.S.C. § 77q(a) ("§ 17a") (Count II); Count III—the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 et seq. ("RICO"); and, Count IV—the Illinois Consumer Fraud and Deceptive Business Practices Act, Ill.Rev.Stat. ch. 121½, § 261 et seq. Plaintiffs also alleged the following Illinois common law claims: Count V—breach of fiduciary duty; Count VI—fraud; and Count VII—against MWE and Hucker only, negligence.

In two sets of well-written and well-reasoned briefs,[1] defendants asserted a number of grounds for dismissing each of the five counts in the complaint. Plaintiffs, in equally articulate papers, countered each of the substantive arguments in turn. In addition, in the period after the motions became fully briefed, both sides promptly informed the court of new decisions which could bear on the resolution of the issues joined in the briefs. This court commends the attorneys involved in this case for their skillful advocacy of their clients' causes.

DISCUSSION

Count I

In Count I, plaintiffs seek to recover the losses on their investments in the limited partnerships on the grounds that defendants failed to disclose the earlier loan problems

[1] Faestel, FI and Petren jointly filed one motion to dismiss; MWE and Hucker together filed a separate motion to dismiss. With a few exceptions not relevant to this court's ruling, both motions raised the same grounds in seeking dismissal of the complaint.

and securities litigation. To recover under a § 10(b) or Rule 10b-5 private cause of action, plaintiffs must first prove that defendants violated the statute or the rule.

To do so, plaintiffs must establish the following:

(1) that defendants intentionally or recklessly;

(2) misrepresented or omitted to disclose

(3) material facts;

(4) in connection with the purchase or sale of a security.[2]

---

[2] Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange—
>
> * * * * * *
>
> (b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any scheme, device or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances in which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Plaintiffs here ground their claim for relief on an alleged violation of Rule 10b-5(b).

Beck v. Cantor, 621 F.Supp. 1547, 1553 (D.C. Ill. 1985). *See also Harris v. Union Electric Co.*, 787 F.2d 355, 362 (8th Cir.), *cert. denied*, ___ U.S. ___, 107 S.Ct. 94, 93 L.Ed.2d 45 (1986); *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1046 (11th Cir. 1987).

Showing a § 10(b) or Rule 10b-5 violation is not, however, enough. To recover, plaintiffs must also prove that they justifiably relied on defendants' misrepresentations or omissions in making their investments and that the misrepresentations or omissions "caused" the losses. *Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987). *See also Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522 (7th Cir. 1985).

Defendants do not contest, for the purposes of the motion to dismiss, that plaintiffs have properly pled the elements of a § 10(b) or Rule 10b-5 violation. Nor do they challenge plaintiffs' contention that, because the claims here are predicated on material omissions, "reliance and 'causation in fact' are presumed." *Beck v. Cantor*, 621 F. Supp. at 1556. *See Affiliated Ute Citizens v. United States*, 405 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972); *Kademian v. Ladish Co.*, 792 F.2d 614, 627 (7th Cir. 1986) (in § 10(b) cases, "causation [in fact] and reliance are closely related"); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1049 (7th Cir.) ("With materiality established, reliance in an omissions case is presumed."), *cert. denied*, 434 U.S. 875, 98 S.Ct. 225, 54 L.Ed.2d 155.

Nevertheless, defendants do insist that Count I must be dismissed because plaintiffs have failed to allege a second element necessary to establish legal causation in a § 10(b) case—that defendants' material omissions were causally linked to the loss in value of plaintiffs' investments. Stated differently, defendants claim that Count I

fails to state a claim upon which relief may be granted because, although plaintiffs have sufficiently pled "transaction causation"—that the nondisclosures "caused" plaintiffs to invest in Petren A and Petren B— they have not pled "loss causation"—that the nondisclosed information "caused" the subsequent decline in the value of the partnership interests.

The majority of courts to consider the issue have stated that "loss causation" is an essential element in a private action under § 10(b) or Rule 10b-5:

> [T]he causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

Huddleston v. Herman & MacClean, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983); *Currie v. Cayman Resources Corp.*, 835 F.2d 780 (11th Cir. 1988); *Platsis v. E.F. Hutton & Co.*, 642 F. Supp. 1277, 1299-1300 (W.D. Mich. 1986), *aff'd*, 829 F.2d 13 (6th Cir. 1987). *See also Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 924 (11th Cir. 1987) (Clark, J., concurring); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n. 5 (D.C. Cir. 1987); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 n. 16 (3d Cir. 1981) ("reliance [and thus 'causation in fact'] is necessary but not sufficient to establish [legal] causation]"), *cert. denied*, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982).

In at least one circuit, however, there is an exception to this rule:

> A plaintiff 'should not have to prove loss causation where the evil is not the price the investor paid for the security, but the broker's fraudulent inducement of the investor to purchase the security.'

Kafton v. Baptist Park Nursing Center, 617 F.Supp. 349, 350 (D. Ariz. 1985), *quoting, Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984). Furthermore, although the Second Circuit has stated repeatedly that to establish causation for purposes of § 10(b), a plaintiff must "show both *loss causation* . . . and *transaction causation*," *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2d Cir. 1986), *cert. denied*, 474 U.S. 1058, 106 S.Ct. 800, 88 L.Ed.2d 776 (1987), *quoting, Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed. 2d 467 (1975), its recent decision in *Manufacturer's Hanover Trust Company v. Drysdale Securities Corp.*, 801 F.2d 13 (2d Cir. 1986), *cert. denied*, ____ U.S. ____, 107 S.Ct. 952, 93 L.Ed.2d 1001 (1987), at least implicitly calls those decisions into question.[3]

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[3] Although the Court in *Manufacturer's Hanover* stated that "loss causation" remains an essential element in § 10(b) cases, it then proclaimed that "loss causation" can be established by showing the defendants could have reasonably foreseen that their misstatements would induce the plaintiffs to invest. While that is, to be sure, a *proximate cause* requirement, it most certainly is not a "*loss causation*" requirement, at least not "loss causation" in the sense that term has been used by other courts.

Indeed, by equating "loss causation" with "proximate causation," the court oversimplified and confused the central issue involved in these cases. The question is not whether plaintiffs must establish "proximate" as well as "but-for" cause in § 10(b) cases; proximate cause is always a prerequisite to recovery. *See First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775 (7th Cir. 1988) (dismissing § 10(b) case against defendants for alleged fraud in connection with sale of McCormick A bonds because al-

(Footnote continued on following page)

Nevertheless, this court has determined that plaintiffs here must allege "loss causation" if they are to survive a motion to dismiss, for a number of reasons.

First, this court must give deference to the Third Circuit's recent ruling affirming a district court's dismissal—for failure to allege "loss causation"—of a § 10(b) claim against the same defendants, and grounded on the same facts, as the instant case. *See Sims v. Faestel,*[4] 683 F. Supp. 1281 (E.D. Pa. 1986), *aff'd mem.*, 813 F.2d 399 (3d Cir. 1987).

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[3] *continued*

leged fraud was a "but-for" but not a "proximate" cause of plaintiff's loss on purchase of McCormick B bonds, which defaulted after the funds raised from their issuance were used to repay the McCormick A bond holders). Rather the question is whether the plaintiff must prove not only that the violation proximately caused the investment decision, but that it proximately caused the economic harm as well.

The oversimplification in *Manufacturer's Hanover* led defendants here to argue erroneously that that ruling supports their "loss causation" argument. In fact, the *dicta* in that case—that to show loss causation plaintiffs must prove that the *investment decision* "was either a direct result of the misleading statement or one which could reasonably have been foreseen," *id.* at ¶ 94,394; *see infra* n. 6—would, if adopted by this court, defeat the instant motions to dismiss.

[4] Defendants have argued that, because *Sims* was brought as a class action on behalf of all of the limited partners in the Petren partnerships, this court should apply collateral estoppel to the issues resolved in that case. The district court in *Sims*, however, dismissed the case without certifying the class, so issue preclusion is inappropriate. Nevertheless, the fact that the decision was based on nearly identical questions of fact and law, and was affirmed by the Third Circuit, mandates that this court give it deference here. *Premier Electric Construction Co. v. N.E.R.C.*, 814 F.2d 358, 367 (7th Cir. 1987); *Colby v. J.C. Penney Co.*, 811 F.2d 1119, 1123-24 (7th Cir. 1987).

Second, while the Seventh Circuit has never squarely addressed the issue,[5] two district courts in this circuit have recently dismissed § 10(b) claims for failing to allege "loss causation". *See Rankow v. First Chicago Corporation*, 678 F.Supp. 202 (N.D. Ill. 1987); *TFG, Inc. v. Sullivan*, No. 86-4176, slip op. (N.D. Ill. Oct. 20, 1986) [Available on WESTLAW, 1986 WL 11996].

Third, the courts which have rejected a "loss causation" requirement have done so in cases involving a particular and special form of § 10(b) violation—stock broker "churning" of client accounts. *See, e.g., Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767 (9th Cir. 1984); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). In these cases, stock brokers cheat their clients out of commissions by fraudulently inducing them to purchase excessive amounts of stock. The fraud generally involves misrepresentations as to the brokers' skills in picking winning stocks or the potential gains available to the customers through a particular investment strategy. *See, e.g., Marbury Management Inc. v. Kohn*, 629 F.2d 705 (2d Cir.) (trainee at brokerage firm fraudulently misrepresented himself as a "portfolio management specialist" and thereby persuaded plaintiffs to purchase highly speculative stocks), *cert. denied*, 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). Courts have held these brokers accountable not only for their commissions, but also for the

[5] The Seventh Circuit has used the term "loss causation" in referring to the requirement that a § 10(b) or Rule 10b-5 plaintiff prove that he suffered a financial loss as a result of the violation. *See Kademian v. Ladish Co.*, 792 F.2d 614, 627 (7th Cir. 1986). The court did not address the requisite causal nexus between the alleged violation and the harm suffered. *Compare Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700 (7th Cir. 1987) (same proposition without term "loss causation").

customers' losses on their investments, despite the fact that it was the decline in the overall market, not the misinformation which caused the stocks' prices to fall.[6] *See Hatrock v. Edward D. Jones & Co., supra*; *Chasins v. Smith, Barney & Co., supra*; *Marbury Management Inc. v. Kohn, supra*; *But see In re Catanella and E.F. Hutton & Co.*, 583 F.Supp. 1388 (E.D. Pa. 1984).

These cases provide weak authority for rejecting a "loss causation" requirement in the instant case, for two reasons. First, the courts permitting full recovery of the losses appear (at least implicitly) to have predicated their decisions on the theory that, while the brokers' misrepresentations did not cause the stocks' prices to fall, they did cause the customers to overestimate—on the basis of their brokers' "advice"—the value of their investments at the time of the purchases. *See Bennett v. United States Trust Co. of New York*, 770 F.2d at 314 (explaining *Marbury Management:* "In essence, the stock in question did not have the value represented by the broker."). Under this theory, the subsequent decline in the stocks' prices served, in effect, as proxies for the "losses" which the clients suffered at the *time of their investments*—losses which clearly fall within the parameters of the "loss causation" requirement. *See, e.g., Sharp v. Coopers & Lybrand*,

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[6] Although *Manufacturer's Hanover Trust Company v. Drysdale Securities Corp., supra*, was not a broker case, it does not necessarily deviate from this rule. Although, as noted *supra* n. 3, the Court there did not require "loss causation" as that term has been used in this opinion, the existence of "loss causation" in that case was clear. *See Zoelsch v. Arthur Andersen & Co.*, 824 F.2d at 35 n. 5 (explaining *Manufacturer's Hanover* as requiring *both* lost causation and transaction causation). Accordingly, the narrow holding of that case was simply that plaintiff had sufficiently established "transaction causation"—that is, a proximate causal nexus between the § 10(b) violation and the subsequent purchase.

649 F.2d 175 (3d Cir. 1981) (where misinformation provided by defendant results in plaintiff paying too much, or receiving too little for his stock, "loss causation" exists), *cert. denied*, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982). Thus, the churning cases may not even represent exceptions to the loss causation requirement.

Moreover, to the extent that these cases cannot be reconciled with those requiring "loss causation," they represent an unwarranted break with traditional notions of legal causation. In his dissent in *Marbury Management*, Judge Meskill refused to read the majority's imposition of liability against the defendant as anything but a complete rejection of the "loss causation" requirement. He then proceeded to condemn the majority's result, in an opinion recently cited with approval by the Seventh Circuit:

> I share my colleague's condemnation of [defendant's] misconduct and express no view as to whether recourse may lie in an appropriate court under a theory more feasible than the one advanced by plaintiffs. In approving [defendant's] present sanction, however, the majority is more righteous than right, for its decision abandons the traditional understanding of causation in the context of the sale of securities induced through misrepresentation, disregards governing precedent and extends the reach of § 10(b) beyond that of its common law antecedent to provide for recovery in cases in which federal policies are offended by such expansion.

Marbury Management Inc. v. Kohn, 629 F.2d at 717 (Meskill, J., dissenting), *cited with approval*, *First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775 (7th Cir. 1988).

What Judge Meskill said in a case involving a stock broker selling stocks to his less experienced customers

applies with even greater force in cases involving sales of partnership interests in obviously speculative capital ventures. *See Platsis v. E.F. Hutton & Co., supra.* Without condoning securities fraud in any context, this court can see no basis for "transform[ing] the perpetrator of the [securities] fraud into 'an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the [investment].'" *In re Catanella and E.F. Hutton & Co. Securities Litigation*, 583 F.Supp. at 1417, *quoting Marbury Management*, 629 F.2d at 718 (Meskill, J., dissenting). Accordingly, this court will adhere to the traditional common law rule that "if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery." Prosser, *Law of Torts* § 100 at 732 (4th ed.) (footnotes omitted).

Plaintiffs here have not even attempted to plead that the information defendants allegedly omitted from the Offering Memoranda caused the decline in their Petren A and Petrin B partnerships interest. Perhaps the ventures became worthless because defendants were incompetent or irresponsible; if so, plaintiffs may be able to plead, in an amended complaint, a causal nexus between the non-disclosures and their economic loss. On the other hand, the investments may be worthless for reasons completely unrelated to the non-disclosures; in that case, an amended complaint would not only fail, but might be subject to sanctions. Whatever the case, one thing is clear: Count I of the complaint as it now stands must be dismissed without prejudice.

Count II

Count II alleges the same facts as Count I but seeks relief under § 17(a). This court will not tarry long in dispensing with this claim. First, for the reasons set forth most recently by the Ninth Circuit in *In re Washington Public Power Supply System Securities Litigation*, 823 F.2d 1349 (9th Cir. 1987) (*en banc*), and already articulated by a number of district judges in this circuit, *e.g., Beck v. Cantor*, 621 F.Supp. 1547, 1553 (D.C. Ill. 1985) (Rovner, J.), this court holds that there is no implied private right of action under § 17(a). Moreover, even were such an implied right of action available, plaintiffs could not state a claim for relief under it here. *See Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 531 (7th Cir. 1985) (where allegations under § 10(b) and § 17(a) overlap, the § 17(a) claim "adds nothing to the plaintiff's arsenal"). Accordingly, Count II will be dismissed with prejudice.

Count III

In Count III, plaintiffs seek treble damages under RICO, 18 U.S.C. 1964(c),[7] on the grounds that the violations of § 10(b) and § 17(a) alleged in Counts I and II constitute a "pattern of racketeering activity,"[8] that through this

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[7] 18 U.S.C. § 1964(c) provides:

> Any person injured in his business or property by reason of a violation of § 1962 of this chapter may sue thereon in any United States district court and shall recover threefold the damages he sustains and the cost of the suit including a reasonable attorney's fee.

[8] 18 U.S.C. § 1961(5) states that:

> a "pattern of racketeering activity" requires at least two acts of racketeering activity, one of which occurred within ten years after the effective date of this chapter and the last of which

(Footnote continued on following page)

"pattern of racketeering activity" defendants conducted the affairs of the Petren IA and Petren IB "enterprises," and that plaintiffs were damaged "by reason of" this activity.

Defendants have moved to dismiss on three grounds: First, the insufficiency of the § 10(b) and § 17(a) claims means that defendants have failed to sufficiently plead *any* predicate acts of racketeering activity; second, even if plaintiffs have properly pled securities violations, they have pled only a single violation with respect to each Petren "enterprise" and thus have failed to properly allege a RICO violation; and, third, even if plaintiffs have sufficiently alleged a RICO violation, they lack standing because they have not alleged how they were injured by it.

The first and third arguments indicate that defendants misconstrue the interaction between the securities laws and the RICO claims predicated on them. As defendants themselves argued, plaintiffs failed to state a claim under Counts I and II not because defendants did not violate the securities laws, but rather because courts, in implying private rights of action under these laws, have imposed an additional "loss causation" requirement. *See United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) ("It

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[8] *continued*

occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity.

The term "racketeering activity" encompasses a broad scope of criminal activity including "any act 'chargeable' under several generically described state criminal laws, any act 'indictable' under numerous specific federal criminal provisions including mail and wire fraud, and any 'offense' involving bankruptcy or securities fraud or drug-related activities that is 'punishable' under federal law." *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) (summarizing 18 U.S.C. § 1961(1)).

is only because the judiciary has created a private cause of action for damages [under § 10(b)] the "contours" of which are not described in the statute, that standing in such cases has become a pivotal issue."), *cert. denied*, 464 U.S. 863, 104 S.Ct. 193, 78 L.Ed.2d 170 (1983).

This judicially-imposed limitation on such rights of action simply does not apply to the statutorily-created RICO claims. *See Sedima, S.P.R.L. v. Imrex Corp.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985). To recover under § 1964(c), plaintiffs need only establish that they were injured "by reason of" a RICO violation. And to prove a RICO violation, plaintiff need only prove a pattern of "fraud in the sale of securities." They need not allege nor prove that they could actually recover in a private action under the securities laws.

Thus, assuming for the moment that the alleged violations of §§ 10(b) and 17(a) constituted a "pattern of racketeering activity," plaintiffs need only allege, for the purposes of their RICO claim, that the securities violations "caused" them to purchase stock that subsequently declined in price. *Haroco, Inc. v. American National Bank & Trust of Chicago*, 747 F.2d 384 (7th Cir. 1984), *aff'd*, 473 U.S. 606, 105 S.Ct. 3291, 87 L.Ed.2d 437 (1985). This much they have clearly done.[9] Accordingly, defendants' first and third arguments for dismissing the RICO claim must fail.

Defendants' second argument for dismissing Count III, however, will carry the day. In this court, plaintiffs have alleged that defendants conducted each Petren partner-

[9] Defendants conceded in the first part of their brief that plaintiffs had pled "transaction causation."

ship through a single distinct act of securities fraud[10]—and that the two acts, taken together, constitute a "pattern of racketeering activity" in violation of § 1962(c). Defendants maintain that, because plaintiffs have identified each Petren partnership as a separate enterprise, and because in order to allege a § 1962(c) violation, plaintiffs must point to a single enterprise which defendants conducted through a pattern of racketeering activity, this count fails to state a RICO claim. Defendants are clearly correct here.

While considerable debate has focused on whether and when two predicate racketeering acts are sufficiently "related and continuous" to constitute a "pattern of racketeering activity," there has never been any doubt that, to state a claim under § 1962(c), a RICO plaintiff must identify a single enterprise, the affairs of which the defendant conducted through a pattern of such activity. Indeed, the words of the statute itself make this clear:

> It shall be unlawful for any person employed by or associated with *any enterprise* . . . to conduct or participate . . . in the conduct of *such enterprise's* affairs through a pattern of racketeering activity. . . .

18 U.S.C. § 1962(c) (emphasis added). *See also Sedima, S.P.R.L. v. Imrex Corp.*, 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) ("the essence of the [§ 1962(c)] vio-

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[10] Although the complaint attempts to identify two predicate "acts" with respect to each Petren enterprise by alleging each securities violation twice—once as a violation of § 10(b), then as a violation of § 17(a)—plaintiffs do not pursue this position in their response brief. They are right not to do so. A single criminal act clearly cannot constitute a "pattern of racketeering activity," regardless of how many statutes it violates, if for no other reason than that it cannot possibly satisfy the "continuity" prong of the "relationship plus continuity" requirement.

lation is the commission of the [predicate] acts in connection with the conduct of *an enterprise*") (emphasis added).

Because plaintiffs have not alleged a single enterprise, the affairs of which defendant conducted through two or more acts of racketeering activity, this court will grant defendants' motion to dismiss Count III. However, because it is possible that plaintiffs may yet be able to remedy the defect in this count, the dismissal will be without prejudice.

Counts IV-VII

Counts IV through VII are state law claims brought pursuant to this court's pendent jurisdiction. Since the federal claims have all been dismissed, this court has decided not to exercise its discretion to hear these claims and will instead dismiss them without prejudice. Should plaintiffs seek to file an amended complaint, they can reallege the state law claims at that time.

CONCLUSION

Count II is dismissed with prejudice. The rest of the complaint is dismissed without prejudice.

APPENDIX 3

699 F.Supp. 161 (N.D. Ill. 1988)

R. Richard BASTIAN, III; B.P. Loughridge; Ronald D. Rotunda; Marcia Rotunda; General Synergy Investments, an Oklahoma partnership; Gabriel Fernandez; J. Mahar; CMF Associates, an Illinois partnership; Alfred J. Hendron; and M.T. Davidson, Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; Faestel Investments, Inc., an Illinois corporation; David J. Faestel; McDermott, Will & Emery, a partnership; and Brian Hucker, Defendants.

No. 86 C 2006.

United States District Court,
N.D. Illinois, E.D.

Oct. 28, 1988.

* * * * * *

MEMORANDUM OPINION

BRIAN BARNETT DUFF, District Judge.

On March 7, 1988, this court dismissed the seven-count complaint brought by R. Richard Bastian III and others against Petren Resources Corporation; Faestel Investments, Inc. ("FII"); David J. Faestel; McDermott, Will & Emery; and Brian Hucker. See *Bastian v. Petren Resources Corp.*, 681 F.Supp. 530 (N.D. Ill. 1988). All but one of the original counts were dismissed without prej-

udice. The plaintiffs have corrected some of the defects of their original complaint, added a new count, dropped defendant Hucker, and submitted an Amended Complaint.

In Count 1 of their new complaint, the plaintiffs allege a violation of § 1962(c) of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), codified at 18 U.S.C. § 1961 et seq. (1982). In Count 2 the plaintiffs allege that Petren violated § 1962(a) of the RICO statute, while in Counts 3-6 they allege various claims under Illinois law. The defendants have moved for dismissal of Counts 1 and 3-6 of the Amended Complaint under rule 12(b)(6) Fed.R. Civ.P. Additionally, defendant Petren moves for dismissal of Count 2 for plaintiff's failure to comply with Rule 9(b), Fed.R.Civ.P.

The facts alleged in the Amended Complaint are essentially the same as those alleged in the original complaint, which this court canvassed in its earlier opinion. The gravamen of the RICO claim stated in Count 1 is that the defendants drafted an Offering Memorandum that omitted material information. The plaintiffs claim that had the Memorandum contained this information, they would not have invested in limited partnership shares sold through the Memorandum, shares which declined sharply in value. Count 1 concludes: "Plaintiffs have been injured in their business and property by reason of the defendant's [sic] violations of 18 U.S.C. § 1962(c) and (d)." Complaint at ¶ 35.

The defendants contend that the plaintiffs have not alleged causation sufficiently in Count 1 to recover under 18 U.S.C. § 1964(c), the civil damages provision of RICO. Section 1964(c) provides:

> Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States

> district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

The defendants draw this court's attention to the words "by reason of." They argue that these words contain requirements of "but for" and "proximate" causation, so familiar from the law of torts. See W. Page Keeton, et al., The Law of Torts §§ 41-42 (5th ed. 1984). The defendants submit that the plaintiffs have not alleged proximate causation.

The proper place to begin any inquiry into what a statute requires (although one would not know it from the briefs submitted in this case) is the language of the statute itself. Section 1964(c)'s phrase "by reason of" does not explicitly require proximate causation. It could very well require only cause in fact, if reduced to its most simple form. The context of the phrase does not cast light on its meaning, and so this court must rely on other means of construing it. One method is to determine if either construction would render § 1964(c) unreasonable, but this method does not help: reading "by reason of" to contain only "but for" causation would be reasonable, given Congress's desire in enacting RICO to fight organized crime aggressively. See *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498-99, 105 S.Ct. 3275, 3285-86, 87 L.Ed. 2d 346 (1985) (reviewing legislative purposes of RICO). On the other hand, it is not inconceivable that Congress would have required proximate causation, given the widespread use of the concept in civil law.

The plain words "by reason of" in § 1964(c), their context, and the reasonableness of the two suggested constructions of the phrase do not exhaust the tools of this court for interpreting the statute. This court has further recourse to the history of the Organized Crime Control

Act of 1970, Pub.L. 91-452, 84 Stat. 922, the act that introduced RICO into the federal system. As the Supreme Court noted in *Sedima*, 473 U.S. at 487-88, 105 S.Ct. at 3280-81, Congress modeled RICO's treble damages provisions on similar civil remedies provided under the federal antitrust laws. While Congress never directed its attention specifically to RICO's "by reason of" language while considering the Organized Crime Control Act, see Organized Crime Control Act of 1970, H.Rep. No. 91-1549, 91st Cong., 2d Sess. (Sept. 30, 1970) U.S. Code Cong. & Admin. News 1970, p. 4007 (reporting House version of S. 30, which contained RICO's civil damages provision); 116 Cong. Rec. 35191-217 (Oct. 6, 1970) (House debate on Organized Crime Control Act); *id.* at 35287-364 (Oct. 7, 1970) (conclusion of House debate); *id.* at 36281-96 (Oct. 12, 1970) (Senate debate), members of both houses repeatedly acknowledged that they were mobilizing "both the criminal and civil mechanisms of the Sherman Act and other antitrust statutes against the barons of organized crime." *Id.* at 35201 (Rep. Poff). See also *id.* at 35196, 35197, 352000 (Reps. Celler, McCulloch, and Rodino, to the same effect); *id.* at 36294, 36296 (Sens. McClellan and Dole, to same effect).

These statements suggest that the antitrust laws are instructive as to the causation required under RICO. While the Court in *Sedima* noted that there are some indications in the legislative precursors of RICO that the courts should not rely too heavily on the antitrust laws in interpreting § 1964(c), see *Sedima*, 473 U.S. at 498-99, 105 S.Ct. at 3285-86 (quoting comments of American Bar Association in 1969 on a proposed RICO-like amendment to the Sherman Act, warning that the strict standing and proximate cause requirements of the antitrust laws would hamper efforts to combat organized crime), these historical

references should not prevent a court from referring to the antitrust laws altogether. Congress did not ignore the antitrust laws, and neither should this court.

The most direct antitrust analogy to RICO is found in § 4 of the Clayton Act, 15 U.S.C. § 15 (1982). This section contains the exact "by reason of" language found in RICO. The Supreme Court has interpreted this language to impose, for lack of a better term, a "proximate cause" requirement on Clayton Act treble damages claims. See *Associated General Contractors v. Carpenters*, 459 U.S. 519, 529-37, 103 S.Ct. 897, 903-08, 74 L.Ed.2d 723 (1983). In *Carpenters*, the Court traced the history of the common law's influence upon the Clayton Act and concluded that, in enacting the broad remedial provisions of the Clayton Act, " 'Congress did not intend to allow every person tangentially affected by an antitrust violation to maintain an action to recover threefold damages for the injury to his business or property.' " *Id.* at 535, 103 S.Ct. at 907, quoting *Blue Shield of Virginia v. McCready*, 457 U.S. 465, 477, 102 S.Ct. 2540, 2547, 73 L.Ed.2d 149 (1982). Congress intended instead to include those limitations of the common law which traditionally have limited the scope of a tortfeasor's liability. While the Court hesitated to employ the words "proximate cause" (or even the seemingly infinite variations of that term, see *Carpenters*, 459 U.S. at 535 n. 32, 103 S.Ct. at 907 n. 32), it was clear in its holding that the Clayton Act required the federal courts to examine, "as was required in common-law damages litigation in 1890, . . . the plaintiff's harm, the alleged wrongdoing by the defendants, and the relationship between them." *Id.* at 535, 103 S.Ct. at 907.

Like the Court in *Carpenters*, this court hesitates to use the term "proximate cause" too loosely. Nevertheless, it is appropriate for this court to evaluate the plaintiff's

harm, the alleged wrongdoing of the defendants, and the relationship between them in civil RICO actions brought under § 1964(c), as this court would in a case brought under § 4 of the Clayton Act. While the court believes that it is the first court in this circuit to find that § 1964(c) requires a showing of proximate cause, it should be noted that the Seventh Circuit suggested it in dicta in *Haroco v. American Nat. B. & T. Co. of Chicago*, 747 F.2d 384, 398 (7th Cir. 1984):

> This holding by no means renders superfluous the requirement in section 1964(c) that the plaintiff be injured "by reason of" a violation of section 1962. As we read this "by reason of" language, it simply imposes a proximate cause requirement on plaintiffs. The criminal conduct in violation of section 1962 must, directly or indirectly, have injured the plaintiff's business or property. A defendant who violates section 1962 is not liable for treble damages to everyone he might have injured by other conduct, nor is the defendant liable to those who have not been injured. This causation requirement might not be subtle, elegant or imaginative, but we believe it is based on a straightforward reading of the statute as Congress intended it to be read.

More recently, the Seventh Circuit has suggested that whenever Congress creates a private right of action for injuries sustained "by reason of" a violation of state or federal law, it obliges a plaintiff to demonstrate a causal connection "roughly equivalent to the causal connection required to establish common law tort liability"—absent an express indication to the contrary. See *Zepik v. Tidewater Midwest, Inc.*, 856 F.2d 936, 942 (7th Cir. 1988) (interpreting § 23(a) of Consumer Products Safety Act, codified at 15 U.S.C. § 2072(a)). This court thus believes that it is proper for it to look for "proximate cause" in claims brought under § 1964(c) of RICO.

Proceeding with this in mind, the court finds that the plaintiffs have failed to allege proximate cause in Count 1. The plaintiffs allege that they purchased limited partnerships interests and that those interests are now worthless. The plaintiffs contend further that the defendants violated §§ 1962(c)-(d) by marketing the partnership interests, using an Offering Memorandum that omitted material information in violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 270.10-5 (1988), and § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). The Amended Complaint, however, fails to take the matter any further. As the Court noted in *Carpenters*, proper causation requires a relationship between the alleged violation of law and the harm that resulted from the violation. Here, the plaintiffs allege no relationship beyond "but for" causation: had they known the facts omitted from the Offering Memorandum, they would not have purchased the partnership interests.

Of course, under the Federal Rules of Civil Procedure, plaintiffs need not allege each and every fact relevant to their complaint. Nevertheless, this court cannot find even a suggestion of a relationship between the harms claimed and the securities law violations alleged here sufficient to demonstrate proximate causation. According to the Amended Complaint, the defendants failed to disclose that (1) they faced lawsuits in connection with other ventures that they had promoted; (2) Faestel and FII had defaulted on loans obtained with respect to these other ventures; (3) Petren had been established solely to promote limited partnerships and had no previous operating history; (4) Petren was the alter ego of Faestel and FII; (5) Faestel had "extreme financial difficulties"; (6) Petren had fired its president and chief petroleum engineer for incompe-

tence and recklessness; (7) Faestel and McDermott, Will failed to disclose their knowledge that the limited partnerships had little chance to realize a return on investment; and (8) Faestel and McDermott, Will misrepresented the potential earnings and returns on investment of the 1981A and 1981B Petren limited partnerships. See Amended Complaint at ¶¶ 17, 34.

Amidst all of these allegations, one cannot find the crucial element of a § 1964(c) claim: an allegation that any of these defendants' *omissions* lead to the decline in the value of the plaintiffs' investments. Some of the things that were the subject of the omitted material might have been relevant to the loss: for example, if Petren's allegedly incompetent and reckless president and petroleum engineer sank Petren's capital into dry holes, Petren's limited partners could legitimately connect *that* act with the loss that they suffered. But that is not what the plaintiffs do here. Instead, they claim that by the defendants' silence, Petren lost money. Silence could mean disaster in any number of businesses—broadcasting, for example—but the court fails to understand how it was disastrous in this case.

The plaintiffs contend that this court already resolved the issue of causation in its previous opinion. See *Bastian*, 681 F.Supp. at 537. There this court decided that RICO did not impose a requirement of "loss causation" on § 1964(c) claims, unlike that imposed on claims brought under § 10(b) of the Securities and Exchange Act. The loss causation requirement of § 10(b) is fairly close to the traditional notion of proximate cause. Both concepts involve an examination of the relationship between the alleged violation of the law and the loss claimed to have resulted from the violation. See *id.* at 533-36. This court stands by its earlier decision that RICO does not require loss

causation but as demonstrated above, RICO requires proximate causation. When the RICO violation is built upon a foundation of § 10(b) claims, in most cases the failure to prove loss causation under § 10(b) will result in a failure to prove proximate causation under § 1964(c) of RICO. That is the case here.

This court thus dismisses Count 1 for failure to state a claim. As for Count 2, it names only one defendant, Petren. Petren has not raised the proximate cause argument with respect to Count 2 (it felt content with an objection to the plaintiffs' lack of a particular allegation of fraud), but this court believes that Petren should have raised the argument. Count 2 suffers from the same defect as Count 1, differing only in that Count 2 states that Petren received income from the allegedly illegal securities activity outlined in Count 1 to injure the plaintiffs in their business and property. See Amended Complaint, Count 2 at ¶¶ 29-33. The plaintiffs do not suggest, however, how Petren's receipt of income led to a loss in the value of their interests in Petren. In most businesses, the receipt of income by an entity usually enriches the entity's owners. This court believes that, absent further allegation, Count 2 does not state a sufficiently close causal relationship between Petren's receipt of allegedly illegal income and the plaintiffs' losses.

This court thus dismisses Count 2 for failure to state a claim.* As for Counts 3-6, the defendants suggest that

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* In *Doe on Behalf of Doe v. St. Joseph's Hosp.*, 788 F.2d 411, 414-16 (7th Cir. 1986), the Seventh Circuit noted that *sua sponte* dismissals for failure to state a claim upon which relief can be granted are permitted "so long as a sufficient basis for the court's action is apparent from the plaintiff's pleading." Such dismissals are a proper means of shaping litigation, and are disfavored only

(Footnote continued on following page)

this court should exercise its pendent jurisdiction and dismiss these counts for the plaintiffs' failure to state any claim. The defendants acknowledge that this would be an unusual practice for a federal court. Typically, the dismissal of federal claims ends federal jurisdiction over a case, and so it is the usual practice of the federal courts to dismiss any pendent state claims for lack of jurisdiction once the federal claims are gone. A court will retain jurisdiction over state claims only in exceptional circumstances, such as those in *Graf v. Elgin, Joliet and Eastern Ry. Co.*, 790 F.2d 1341 (7th Cir. 1986). In *Graf*, the Seventh circuit reviewed the decision of a federal district court to dismiss a single-count complaint on the merits, even though it ultimately appeared that the count arose under Illinois law. The Seventh Circuit upheld the district court's decision, partly for reasons of judicial economy. The court noted that a federal court should retain jurisdiction over state claims after dismissal of all federal claims in cases "where substantial judicial resources have already been committed, so that sending the case to another court will cause a substantial duplication of effort." *Id.* at 1347-48.

This case does not present the same situation as *Graf*, or even a close analogy. In *Graf*, the district court had ruled on the original two-count complaint filed in the case, saw its decision reviewed and reversed in part by the Seventh Circuit, and had received the single remaining count on remand. Further, that count contained mixed

* *continued*

when the court fails to give the parties notice or an opportunity to be heard. In this case, the plaintiffs had notice and a sufficient opportunity to be heard on the issue underlying this court's dismissal of Count 2, the plaintiffs' failure to allege proximate cause. It is the same question that the defendants raised as to Count 1.

questions of state and federal law, so that it was not clear at first blush that it arose entirely under Illinois law. The questions of Illinois law were also similar to those that would have been reached if federal law applied, mostly questions of fair labor practices.

None of the elements that persuaded the *Graf* court to retain jurisdiction is present here. First, unlike *Graf*, this case has not proceeded beyond the pleadings. Neither party has presented motions for summary judgment, motions that typically involve a greater commitment of judicial resources than those expended on motions to dismiss. Neither party has appealed any of this court's decisions in this case, and so this court does not have the benefit of a higher federal court's familiarity with the facts of this case. Second, Counts 3-6 clearly arise under Illinois law. They are labelled as such, and no questions of federal law emerge from them. The defendants' objections to them rest entirely on points of Illinois law. Last, the objections raised to Counts 3-6 have very little to do with the issue canvassed in this opinion, proximate causation. Hence, while having this court resolve the defendants' objections to Counts 3-6 would save the defendants time and money—particularly if the plaintiffs later choose to file their complaint in the Illinois courts—the focus of the *Graf* decision is savings to the judiciary. It probably would take a state court less time to resolve the state law questions raised by the defendants with respect to Counts 3-6, and so this court will decline the opportunity to do the state court's work.

Therefore, this court dismisses Counts 1 and 2 for failure to state a claim. This court also dismisses Counts 3-6 for lack of jurisdiction.

No. 89-1613

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

R. RICHARD BASTIAN, III, B.P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR., and M.T. DAVISSON,

Petitioners,

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a Partnership,

Respondents.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

STEPHEN NOVACK
(Counsel of Record)
DONALD A. TARKINGTON
NOVACK AND MACEY
303 West Madison Street
Suite 1500
Chicago, Illinois 60606
(312) 419-6900

Attorneys for Respondent
MCDERMOTT, WILL & EMERY

Midwest Law Printing Co., Chicago 60611, (312) 321-0220

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MISCELLANEOUS

IN THE

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STATEMENT OF THE CASE

Many of the "factual" assertions made in Petitioners' Statement of the Case and throughout the Petition are incorrectly stated. Most of these discrepancies are addressed in the body of this Response. However, Petitioners' misstatements concerning the allegations of the Complaint and Amended Complaint stand out because they are repeated throughout the Petition and permeate the entire argument. Accordingly, Respondents single out those misstatements and address them here.

Petitioners wrongfully state that their Complaint and Amended Complaint alleged:

- that Petitioners were told that their investments would be "managed by able and experienced industry experts" (Petition, p. 17); and
- that the promoters were, in fact, incompetent and inexperienced (*Id.*).

Petitioners then imply (though never directly argue) that these allegations are sufficient to allege "loss causation". Yet, neither of these allegations appear in the Complaint or Amended Complaint.[1]

With respect to the first "allegation" as to what Petitioners "were told," neither the Complaint nor the Amended Complaint alleged or complained of *any* affirmative representation, let alone a representation concerning the promoters' competence or experience as experts.

[1] The Complaint is the only pleading in which Petitioners attempted to assert a claim under the federal securities laws. Those claims were not reasserted in the Amended Complaint, which was limited to claims under RICO and state law.

The same is true as to the second so-called "fact" or "allegation." Nowhere in the Complaint or Amended Complaint did the Petitioners allege that the promoters were "incompetent," "inexperienced" or anything of the kind. The Complaint alleged three specific non-disclosures, none of which had anything to do with the competence or operating experience of the promoters. (Complaint, ¶ 18, App. 4.) The first had to do with a 1979 lawsuit against two of the promoters, Faestel Investments, Inc. ("FII") and David Faestel ("Faestel"); but the lawsuit did not concern the promoters' competence or experience as operators or managers of oil and gas ventures. (Complaint, ¶ 18(a), App. 4.) The second related solely to an alleged default on a loan related to other ventures and, again, had nothing to do with the competence or experience of the promoters as operators or managers of oil and gas ventures. (Complaint, ¶ 18(b); App. 4.) The third had to do solely with Petren Resources Corp. ("Petren"), the corporate general partner. (Complaint, ¶ 18(c); App. 4.) The allegation was that Petren had been formed as the alter ego of Faestel and FII solely with respect to the Petren programs. Although this allegation arguably related to the experience of *Petren* as a corporate entity, the whole premise of the allegation was that Petren was nothing more than the alter ego of Faestel and FII. Thus, the allegation was self-defeating as to the question of experience because, according to Plaintiffs, it was Faestel and FII who were operating and managing those programs, albeit through Petren's corporate structure.

Indeed, in dismissing without prejudice the Complaint's securities law claims, the district court expressly allowed Plaintiffs the opportunity, if they could do so, to amend their claims to allege that Respondents were "incompetent or irresponsible" and that such incompetence had caused the investment to fail. *Bastian v. Petren Resources Corp.*, 681 F.Supp. 530, 536 (N.D.Ill. 1988). However, Petitioners

did not do so. Instead, in the Amended Complaint they repeated the *identical* three alleged non-disclosures (Amended Complaint, ¶17, App. 21), and abandoned their securities fraud claims altogether. *Bastian v. Petren Resources Corp.*, 699 F.Supp. 161 (N.D.Ill. 1988).[2]

Indeed, any remaining doubt as to whether Petitioners alleged "loss causation" is resolved by Petitioners' own admission in the Seventh Circuit:

> Plaintiffs [*i.e.*, Petitioners] concede that they did not allege "loss causation" in either their original or amended complaint. So neither pleading aids them if this court determines that "loss causation" is an essential element of their claims.

(App. 43.)

Consistent therewith, Petitioners do not even ask this Court to decide the question of whether their pleadings alleged "loss causation". To the contrary, the questions presented for review are limited to two *general* questions which assume that loss causation has not been alleged, and tender to this Court the issue of whether such allegations are required. Thus, the issue of whether Petitioners alleged "loss causation" in the Complaint or the Amended Complaint is not before this Court, and Petitioners' vague arguments with respect thereto should be ignored.[3]

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[2] Indeed, even if the so-called "facts" relating to "competence" had been alleged, Petitioners still did not allege that the so-called "incompetence" caused their loss.

[3] Petitioners' failure to attach their pleadings to their Petition further confirms that they raise no issue as to the interpretation of these pleadings.

REASONS FOR DENYING THE PETITION

I.

The Circuits Faced With The Issue Of Causation In Rule 10b-5 Cases Have Uniformly Required An Allegation Of "Loss Causation" Or Its Equivalent

A. "Loss Causation" Or Its Equivalent Is Not A Novel Concept—It Is Deeply Rooted In The Law

The requirement of proximate or "loss" causation is hardly a novel or revolutionary development in the law. As the Seventh Circuit emphasized below, the concept of loss causation (or its equivalent) is firmly rooted in basic common law:

> Indeed what securities lawyers call "loss causation" is the standard common law fraud rule, merely borrowed for use in federal securities fraud cases. It is more fundamental still; it is an instance of the common law's universal requirement that the tort plaintiff prove causation. . . . No hurt, no tort.

Bastian v. Petren Resources Corp., 892 F.2d 680, 683-84 (7th Cir. 1990). (Citations omitted.)

The application of "loss causation" to the purchase and sale of securities cases is basic:

> [I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors [which] in no way relate to the representations will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered.

W. P. Keeton, Prosser and Keeton On The Law of Torts §110 at 767 (5th Ed. 1984) (footnotes omitted). Likewise:

> [T]here is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. *Although the misrepresentation has in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, it is not a legal cause of the loss for which the maker is responsible.*

Restatement (Second) of Torts § 548A(b) at 107 (1977) (emphasis added).

The concept as applied to Rule 10b-5 was explained in *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983):

> Causation is related to but distinct from reliance. Reliance is a *causa sine qua non*, a type of "but for" requirement: had the investor known the truth he would not have acted. *Causation requires one further step in the analysis*: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? . . . . *The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss* . . . . If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted . . . .

(Emphasis added; citations omitted.)

Phrases such as "loss", "direct" and "proximate" cause are used as shorthand terms to convey the established

principle that a defendant's conduct must be substantially connected not only to the plaintiff's decision to buy a security but also to the events that actually result in the plaintiff's economic harm. More recently, the term "loss causation" has been used. Whatever term is employed, however, the concept is the same.[4]

B. There Is No Conflict Among The Circuits On The Issue Of "Loss Causation" In Rule 10b-5 Claims[5]

Causation is not and never has been a simple, formulaic principle, and a term such as "loss causation" cannot serve as a substitute for analysis or judgment. *See LHLC Corp. v. Cluett Peabody & Co., Inc.*, 842 F.2d 928, 931 (7th Cir. 1988), *cert. denied*, 109 S.Ct. 311 (1988). However, the fact that causation principles have to be applied carefully does not mean there is no consensus on how they should be applied or what their purpose should be.

On the contrary, loss causation is an accepted and governing principle in *every* circuit that has considered this issue in the last fifteen years (*i.e.*, the Second, Third, Fifth, Sixth, Seventh, Eighth, Ninth, Eleventh and D.C. Circuits), beginning with the Second Circuit in *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374 (2nd Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). *E.g.* (listed by circuits), *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986); *Sims v. Faestel*, 638 F. Supp. 1281, 1283 (E.D.

[4] Even the nomenclature of "loss causation" is hardly new in the Rule 10b-5 arena. It has been used and applied in federal securities law cases since at least 1974. See *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 42 U.S. 976 (1975).

[5] Petitioners do not even assert that there is a split in the circuits on the issue of the causation element under RICO. Accordingly, that argument is waived by Petitioners and will not be addressed in this Response.

Pa. 1986), *aff'd* 813 F.2d 399 (3rd Cir. 1987); *Nutis v. Penn Merchandising Corp.*, 610 F. Supp. 1573, 1580-81 (E.D. Pa. 1985), *aff'd*, 791 F.2d 919 (3d Cir. 1986); *Huddleston v. Herman & MacLean*, 640 F.2d at 549; *Platsis v. E.F. Hutton & Co., Inc.*, 642 F. Supp. 1277, 1299-1300 (W.D. Mich. 1986), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); *Bastian v. Petren Resources Corp.*, 892 F.2d at 683-84; *Harris v. Union Electric Co.*, 787 F.2d 355, 367 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); *In re Financial Corp. of America Shareholder Litigation*, 796 F.2d 1126, 1130 (9th Cir. 1986); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988); *see Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n.5 (D.C. Cir. 1987). Petitioners have not cited even one case which has rejected the "loss causation" requirement.

Petitioners' assertion that the Seventh Circuit recognized a split among the circuits is disingenuous. (Petition, p. 21.) The Seventh Circuit did no such thing. To the contrary, that court expressly stated that the cases "greatly preponderate" in favor of loss causation and that any conflict that there may be is within rather than among circuits. *Bastian v. Petren Resources Corp.*, 892 F.2d at 685.

Each circuit in which Petitioners assert there is a so-called conflict will be addressed below. The analysis shows that what Petitioners mistakenly label "confusion and conflict" is nothing more than the application of the causation principle to the *facts* of individual cases. Far from "undercutting" the "loss causation" requirement, these cases strengthen the principle by applying it consistently.

1. The Seventh Circuit

The Seventh Circuit has uniformly required "loss causation"—or its equivalent—in Rule 10b-5 actions. It is true that the phrase "loss causation" was criticized by the

Seventh Circuit as a poor choice of *words* on the ground that it is "ungainly" and can sometimes "hinder rather than facilitate understanding." *LHLC Corp. v. Cluett Peabody & Co., Inc.*, 842 F.2d at 931. However, the court did not criticize the *concept*. Rather, the court expressly held that "loss causation" is a necessary element of a Rule 10b-5 action:

> Ever since *Schlick v. Penn-Dixie Cement Corp.*, courts have been distinguishing between 'transaction causation' and 'loss causation'. . . . The plaintiff *must show both.*

Id. at 931 (citations omitted) (emphasis added). In *LHLC*, the court defined "loss causation" as meaning that an investor cannot recover unless he or she can allege (and then prove) that "the investor would not have suffered a loss if the facts were what he believed them to be". *Id.*

Petitioners incorrectly suggest that in *LHLC* the Seventh Circuit rejected the "loss causation" analysis in favor of the analysis Petitioners advocate. Specifically, Petitioners assert that:

> The Court [sic] explained that when analyzing causation under the securities laws the focus should be on 'whether the information disclosed or withheld affected an investment decision.'

(Petition, p. 21.) However, Petitioners' argument is based on a quote from *LHLC* which is taken out of context in a misleading manner.

In *LHLC*, the plaintiff brought an action under Rule 10b-5 claiming that it had purchased the stock of the defendant's subsidiary at an artificially high price because the defendant had deliberately and materially misrepresented the value of its subsidiary's inventory. The defendant's accountant, Deloitte, Haskins & Sells ("Deloitte"), was also named as a defendant based upon a letter it had

written confirming that the inventory was worth the allegedly inflated amount. Deloitte's letter was written *after* plaintiff already had purchased the stock. After holding that *both* "transaction" and "loss" causation must be alleged, 842 F.2d at 931, the court analyzed whether "transaction" causation could be alleged where the alleged misrepresentation did not take place until after the purchase of the stock by plaintiff.

In analyzing the issue, the court focused on what "transaction" the transaction causation element referred to. Deloitte's letter arguably delayed plaintiff's discovery that the inventory's value was inflated and probably caused plaintiff to delay the filing of its lawsuit. The court noted that the filing of a lawsuit is a "transaction;" thus Deloitte's letter involved *some sort* of "transaction causation." However, the court stated:

> What should happen when the missing information affected a decision not to file a lawsuit about the securities . . . ?
>
> We have suggested in recent years that the appropriate inquiry is whether the information disclosed or withheld affected an *investment* decision . . . . Whether to . . . file a lawsuit is important, but the securities laws do not apply to [such decisions].

LHLC Corp., 842 F.2d at 931. Thus, the language in *LHLC* on which Petitioners rely was explaining only what is meant by *transaction* causation and had nothing to do with "loss" causation. At no point did the court even suggest that "loss causation" or its equivalent was not required to sustain a Rule 10b-5 claim.

In *Rankow v. First Chicago Corp.*, 870 F.2d 356 (7th Cir. 1989), the Seventh Circuit reaffirmed these principles. In that case, the court found that the complaint *sufficiently* alleged "loss causation" and rejected the defendant's attempts to modify *LHLC*'s definition of that term. *Id.*

at 367. In no way did *Rankow* dispense with the loss causation requirement. The Seventh Circuit reaffirmed this principle in the case below. *Bastian*, 892 F.2d at 683-84. Thus, the Seventh Circuit cases are consistent in requiring loss causation.[6]

2. The Second Circuit

Petitioners are also incorrect in their assertion that the Second Circuit's position on "loss causation" is conflicting and confusing. The Second Circuit has consistently required plaintiffs to plead and prove "loss causation" in Rule 10b-5 actions. *E.g., Ryder Energy Distribution Corporation v. Merrill Lynch Commodities, Inc.*, 865 F.2d 492, 493 (2nd Cir. 1989); *Wilson v. Ruffa & Hanover*, 844 F.2d 81, 85-86 (2nd Cir. 1988); *Manufacturers Hanover Trust v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2nd Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987); *Bennett v. United States Trust Co. of New York*, 770 F.2d at 313; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 380-381.

Petitioners nevertheless point to the 1980 case of *Marbury Management v. Kohn*, 629 F.2d 705 (2nd Cir. 1980), *cert. denied*, 449 U.S. 1011 (1980), as an exception which, they argue, creates a conflict within the Second Circuit. However, that case did not directly reject the loss causation requirement. (*Id.* at 708) Moreover, it has not de-

---

[6] The concept that defendants should not be liable under Rule 10b-5 for losses caused by factors or forces not reasonably related to their alleged wrongdoing has long been an accepted principle of law in the Seventh Circuit, irrespective of the phrase "loss causation." *E.g., First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775, 779-80 (7th Cir. 1988) (intervening event breaks chain of causation); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1051 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977) (the malpractice of plaintiff's attorney was the superseding cause of plaintiff's damages, notwithstanding the fact that defendant violated Rule 10b-5).

tracted from the consistent application of loss causation in the Second Circuit. Instead, as even Petitioners recognize, *Marbury*'s majority opinion has been uniformly and repeatedly ignored in favor of its dissent. (Petition, p. 10.) Indeed, after *Marbury*, the Second Circuit has reaffirmed the loss causation principle in the series of cases cited above.

3. The Eleventh Circuit

The Eleventh Circuit has also adopted and consistently applied the loss causation principle to Rule 10b-5 claims. *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989); *Rousseff v. E.F. Hutton Co., Inc.*, 843 F.2d 1326, 1329 (11th Cir. 1988).

Petitioners' contention that the Eleventh Circuit recognized an exception to the application of "loss causation" in *Bruschi* is incorrect. In *Bruschi*, the court expressly confirmed that "loss causation" was a requirement in Rule 10b-5 cases. As the court stated:

> . . . even though the defendant's misconduct induces the plaintiff to make the investment, if the particular loss complained of is caused by supervening general market forces or other factors unrelated to the defendant's misconduct that operate to reduce the value of the plaintiff's securities, the plaintiff is precluded from recovery under Rule 10b-5.

Bruschi v. Brown, 876 F.2d at 1530. The court then applied this principle to the facts of the case before it and found that the plaintiff had created an issue of fact as to whether the alleged misrepresentation related to the reason for the decline in the value of her investment. Thus, contrary to Petitioners' assertion, the Eleventh Circuit did not recognize an exception to "loss causation"; it simply found that the plaintiff had offered sufficient evidence of "loss causation" to defeat a motion for summary judgment. *Id.* at 1531.

4. The Fifth Circuit

Similarly, the Fifth Circuit has consistently and uniformly required loss causation or its equivalent in Rule 10b-5 actions. *E.g.*, *Huddleston v. Herman & MacLean*, 640 F.2d at 549.

Petitioners' characterization of *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), as a case that somehow runs counter to *Huddleston* and that "undercuts" the application of "loss causation" in the Fifth Circuit is disingenuous. In *Shores*, the Fifth Circuit expressly declined to decide the "loss causation" issue because it was not raised by either party. *Id.* at 469 (citing *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 384 (2d Cir. 1974)—Frankel, J. concurring—issue does not have to be addressed if not raised by the parties). Thus, *Shores* was a reliance case and the majority and dissenting opinions dealt with that issue only.

Furthermore, Judge Garza, a member of the *Shores* majority, later authored *Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306 (5th Cir. 1988), a case in which the Fifth Circuit reaffirmed *Huddleston* and its causation requirement in Rule 10b-5 cases. *Id.* at 319.

5. The So-Called Exception To "Loss Causation"

Petitioners' assertion that some courts have created an exception to the "loss causation" requirement where brokers, privities or fiduciaries are involved is a gross overstatement and irrelevant for purposes of this Petition. Indeed, none of the cases cited by Petitioners makes a general exception for brokers, privities or fiduciaries. Specifically, in *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767 (9th Cir. 1984), the Ninth Circuit applied a narrow exception to the "loss causation" requirement where the defendant broker was alleged to have *churned* a customer's account. *Id.* at 773. This exception was nar-

rowly limited to the facts of that case and can in no way be read to set forth a general exception governing cases involving fiduciaries, brokers or privities. Similarly, the other case on which Petitioners rely, *In re Letterman Bros. Energy Securities Litigation*, 799 F.2d 967 (5th Cir. 1986), does not support their assertion. Indeed, in that case, the Fifth Circuit affirmed the district court's directed verdict in favor of the defendants because the plaintiffs had failed to establish any damages. *Id.* at 972. Significantly, the court rejected the plaintiff's argument that they should have been awarded rescission damages and stated:

> To hold BancTexas liable under a rescissional standard 'would be to place on [it] the burden of any decline in the value of securities between the date of the purchase and the date of the sale even though only a portion of that decline may have been proximately caused by the defendants' wrong.'

Id. at 972-73 (citing *Huddleston*, 640 F.2d at 555.)

In all events, for purposes of this Petition, the exception for "churning cases" is irrelevant. Petitioners never alleged or argued below that Respondents were guilty of churning. Nor could they. Respondent McDermott is a law firm which allegedly assisted the sellers in drafting the offering memoranda; it was not a broker, seller or financial advisor. Accordingly, this so-called exception to the "loss causation" requirement has nothing whatsoever to do with this case and is not before this Court.

II.

"Loss Causation" Or Its Equivalent Should Continue To Be A Necessary Element Of A Rule 10b-5 Claim

A. "Loss Causation" Or Its Equivalent Is Fair And Equitable, And Consistent With This Court's Prior Decisions And The Purposes Underlying The Federal Securities Laws

Petitioners ask this Court to overturn every circuit that has confronted the issue of "loss causation" and to simply

discard fifteen years of direct precedent, as well as one of the most fundamental building blocks of Anglo American Jurisprudence—causation. Yet, the so-called "policy" considerations that Petitioners' offer in support of such an extraordinary request cannot withstand the test of careful analysis. In a nutshell, Petitioners contend that:

> [no one] should be concerned with protecting the rights and liabilities of persons who have engaged in intentional fraud (Petition, p. 18)

and that

> there is no reason why [a defendant] should not be compelled to 'insure' that the victims of his fraud suffer no loss (Petition, p. 18).

Petitioners insist that if a person makes alleged misrepresentations or omissions in connection with the sale of stock, he or she thereafter should be held liable for all of the subsequent decline in the value of the stock, even if the allegedly misstated or omitted facts had nothing whatsoever to do with that decline.

Neither Section 10(b) nor Rule 10b-5 expressly provides for the type of *per se* civil liability which the Petitioners are proposing. Thus, any such liability must be implied. In determining whether such rights can be implied, the role of the courts "is limited solely to determining whether Congress intended to create the private right of action asserted by [the plaintiff]." *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979). To carry out this function, the courts are required primarily to rely upon the language of the statute in question and its legislative history. *Id.* Here, Petitioners have pointed to no particular language in Section 10(b) or Rule 10b-5 and to no legislative history which supports the concept that Congress intended defendants to be held liable as *insurers*. The absence of these factors strongly weighs against the implication of the rights and liabilities which Petitioners are proposing.

The only support that Petitioners offer for the adoption of liability without proof of causation is their contention that requiring causation would eviscerate the deterrent effect of the securities laws. (Petition, p. 12.) However, this contention is unfounded. First, a prospective wrongdoer does not know whether his or her fraud will directly cause the potential harm and, thus, must fear liability under Rule 10b-5 even if loss causation is required.

Moreover, Section 10(b) of the 1934 Act is not the only section of the securities laws which addresses fraud in connection with the sale of securities. Other sections of the securities laws, which are aimed at the same conduct, do not require causation. Thus, even assuming that requiring loss causation in Rule 10b-5 actions somehow ameliorates the deterrent effect of the securities laws, these other sections provide sufficient deterrence. For example, Section 12 of the 1933 Act provides that a person who offers or sells a security based upon material misrepresentations or omissions is liable to the purchaser for the consideration paid for the security or for damages if the purchaser no longer owns the security. Section 12 does not require "loss causation". Because a prospective wrongdoer must assume that he or she may be sued under Section 12 without *any* causation requirement, the deterrence objective is met.

In addition, the relevant policy considerations counsel retaining causation as a requirement in Rule 10b-5 claims. When investments are made, the investors assume certain risks, including the risk that unexpected economic events or the unpredictable play of market conditions could destroy the value of their investments. Nowhere is this more clear than in cases like the one at bar where an inherently high-risk investment in oil and gas drilling is at issue. If unexpected economic events do occur, it is only fair that the investor absorb the losses resulting from the risks he assumed just as the investor would fully

benefit from any gains. *See, e.g., Platsis v. E.F. Hutton & Co., Inc.*, 642 F. Supp. at 1299-1300.

This conclusion should not be changed because the investor later discovers that there was a securities law violation in connection with the original purchase—if that violation was unrelated to the economic events that caused the loss. Under such circumstances, regardless of the fraud, the loss results from exactly the risks the investor knowingly assumed and took into consideration when he or she weighed the economic risks and benefits of the investment.[7]

By the same token, requiring that the investor absorb losses resulting from risks he or she agreed to assume is not overly protective of the alleged wrongdoer. Under the "loss causation" concept, if an alleged violation was in fact the reason for the decline in the value of the securities, the alleged wrongdoer *is fully* responsible for the loss under Rule 10b-5 and otherwise. Furthermore, even if the alleged securities law violation did not actually cause the loss, the alleged wrongdoer is still liable for rescission under Section 12.

Based on the above, it is evident that Congress struck a proper and just balance in the federal securities laws. Liabilities to deter and compensate for fraud are present; at the same time, investors continue to be subject to the economic risks they knowingly agreed to assume.

The radical change in the law for which Petitioners are lobbying would result in the courts creating a penalty to be imposed in Rule 10b-5 cases. This would be inappropriate for at least two reasons. First, if such a penalty

[7] Even Petitioners recognize, as they must, that "[a] defendant should not be compelled to bear the consequences of a risk which the investor would otherwise have accepted." (Petition, p. 19.)

is to be created, it should be created by Congress, not this Court. Second, such a penalty would make the promoter an insurer against all of the natural and ordinary risks which the investors knowingly undertook. That would be unfair, even to promoters who have committed a securities law violation. After all, notwithstanding Plaintiffs' irresponsible arguments to the contrary, such persons do continue to have rights deserving of protection under the law.[8] Although a defendant should be held fully accountable for all harm proximately caused by his or her wrongdoing, penalties should not arbitrarily be imposed on a defendant for losses caused by independent factors unrelated to his or her alleged wrongful conduct. As the courts have held:

> To find causation despite an intervening causative factor would transform the perpetrator of the fraud into 'an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock.'

In re Catanella and E.F. Hutton and Securities Litigation, 583 F. Supp. 1388, 1417 (E.D. Pa. 1984); *see Huddleston v. Herman & MacLean*, 640 F.2d at 549.

Perhaps two hypotheticals will even more clearly serve to illustrate the point.

Hypothetical Number 1

The plaintiff was solicited to invest in an oil and gas venture, the sole purpose of which was to develop the Smith Well. At the time of plaintiff's investment the seller knew that the Smith Well was a dry hole, but did not

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[8] For example, if a violation has caused no injury, there can be no Rule 10b-5 claim—even as against a defendant who has made a fraudulent misrepresentation. *Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987).

disclose that fact. In such a case there is "transaction causation." Had the investor known the Well was dry at the time of the investment, the purchase would never have been made. In addition, there is "loss causation." The reason the investment was worthless was that the Well was dry—the very fact not disclosed. In this hypothetical, the investor can allege both "transaction" and "loss" causation. Obviously, the investor has a valid claim under Rule 10b-5.

Hypothetical Number 2

As in hypothetical number 1, the plaintiff was solicited to invest in an oil and gas venture, the sole purpose of which was to develop the Smith Well. Again, the Smith Well turned out to be a dry hole. However, in this hypothetical the seller did not know that the Well was dry at the time the investment was sold to the plaintiff. On the contrary, the seller then believed the Well was going to be a gas-producing well. Nevertheless, the Well later turned out to be dry. As a result, the plaintiff's investment became worthless.

In connection with the sale to the plaintiff, the seller had failed to disclose that the drilling equipment to be used in the venture was not insured. Fortunately, however, the equipment was never damaged. After the Well turned out to be dry and the investment worthless, the plaintiff discovered the seller's omission as to the insurance, and sued under Rule 10b-5. The plaintiff alleged that he never would have invested had he known that the equipment was not insured and, if he had not invested, he never would have suffered the loss caused by the later discovery that the Well was dry. The investor did not allege—nor could he—that the omitted fact concerning the lack of insurance caused the investment to become worthless.

In this hypothetical the investor has adequately alleged "transaction causation"—he alleged that "but for" the omission as to the insurance he never would have invested. However, he did not allege "loss causation" because the particular fact omitted had nothing to do with the ultimate decline in the value of the investment. Even though there was an omission, and one on which the investor based his investment decision, the omission had nothing whatsoever to do with the decline in the value of the investment. Even "if the facts were what [the investor] believed them to be"[9]—*i.e.*, even if the equipment had been insured—the investor still would have suffered the loss.

Does this investor have a claim under Rule 10b-5? Should he be able to sue because his investment became worthless due to no fault of the seller? Isn't the risk that the Well would turn out to be dry exactly the risk every investor assumes in an oil and gas venture? Should the seller retroactively be transformed into a guarantor or insurer that the Well would not be dry just because the absence of insurance was not disclosed? The answer is no.

The so-called "neutral principle" being urged by Petitioners can be further tested by adding additional facts to hypothetical no. 2.[10] Assume that, after the investment in hypothetical no. 2 had been made, the seller got the insurance which he had represented had already been obtained? Even though that would have "cured" the misrepresentation, there would presumably be no effect on "transaction causation"—the plaintiff still would not have invested had he known the equipment was *then* uninsured.

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[9] *See LHLC*, 842 F.2d at 931.

[10] We do not suggest that these additional facts are present in the instant case. They are offered solely to test the principles at issue herein.

Yet, under the "neutral principle" urged by Plaintiffs, the investor would have a claim under Rule 10b-5. Such a "principle" should not become the law.

Likewise, suppose that the Smith Well had initially been very productive and the value of the securities had increased greatly so that the investors could have sold at a profit several years after their investment. However, still later the Well dried up and the value of the securities ultimately declined to zero. Suppose further that the sellers never purchased the insurance but that the lack of insurance did not cause the value of the securities to decline. Again, the intervening increase in value would presumably have no effect on "transaction causation"—the investors originally would not have purchased had they known that the equipment was not insured. But should those investors who did not sell at a profit, but who continued to make the investment decision to hold their securities, have a claim under Rule 10b-5 because, ultimately, the securities became worthless? Under the "neutral principle" urged by Petitioners, Petitioners would say there is a claim because *but for* the insurance misrepresentation they never would have invested.

As these hypotheticals illustrate, the radical shift in the law urged by Petitioners does not pass scrutiny. Should this Court adopt such a revolutionary proposition, it would undermine the well-established and uniform case law concerning the scope of the federal securities laws as well as basic concepts of logic and fairness that have always been at the foundation of tort law. Any such change in these principles as they apply to the federal securities laws should come, if at all, from Congress, not this Court.

Nor do the cases previously decided by this Court and cited by Petitioners alter this conclusion. Those cases are easily distinguished because they either do not address

the issue of causation, do not concern Rule 10b-5, or, when properly read, contradict Petitioners' position.

Petitioners cite *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) for the proposition that common law principles are inappropriate for federal securities law cases. *Capital Gains* made no such holding. On the contrary, this Court applied common law principles in that case; the Court merely held that, over time, the common law principles had changed. *Id.* at 193.

Petitioners also cite *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). The *Basic* case focused on the doctrine of "reliance" and "transaction causation," the only issue presented in that case. That case did not discuss loss causation in any way. Accordingly, *Basic* is inapposite and lends no support to Petitioners' position.

Mills v. Electric Auto-Lite, 396 U.S. 375 (1970) also does not help Petitioners. In *Mills*, material misrepresentations were made in a proxy statement and the proxies thereafter were voted with respect to a corporate merger which was approved. The Court held that the misrepresentations were actionable under Section 14(a) of the Securities Exchange Act of 1934, and remanded the case for a determination of the appropriate remedy, if any. *Mills* did not concern Rule 10b-5. Furthermore, by remanding the case for a determination of the proper remedy, this Court in effect required consideration of the harm actually caused by the proxy misrepresentations in fashioning the appropriate relief. Significantly, the Court stated:

> . . . where, as here, the misleading aspect of the solicitation did not relate to the terms of the merger, monetary relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings or earnings potential of their holdings. In short, damages should be recoverable only to the extent that they can be shown.

Id. at 388-89. Significantly, after remand, the Seventh Circuit affirmed the dismissal of the *Mills* case on the ground that the misrepresentation had caused no harm. *Mills v. Electric Auto-Lite Company*, 552 F.2d 1239, 1249 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

Affiliated Ute v. United States, 406 U.S. 128 (1972) also does not support Petitioners' position. In *Affiliated Ute*, a group of Indians formed a corporation to hold and manage tribal assets. Stock of the corporation was issued to tribal members. The tribe designated a local bank as a transfer agent for the corporation's stock.

The bank agreed that it "would be acting for the individual [Indian] stockholders." *Id.* at 152. As a result, the Indians relied on the bank to inform them of the market value of their shares, which some of the Indians would sell from time to time. Despite this, two officers of the bank secretly created a market in the stock among non-Indians. The bankers periodically induced the Indians to sell their stock to them and the bankers then sold the stock for a much higher price on the secret market the bankers had created. In addition, the bankers induced the Indians to sell their stock to non-Indians at a price below market and secretly took a commission from the non-Indians for arranging these transactions. The bankers did not disclose to the Indians either that they were market makers in the stock or that they were profiting from the stock transactions.

This Court upheld the Indians' claim that the bank officers had defrauded them in violation of Rule 10b-5. In its opinion, the Court dealt with the question of what was necessary for the sellers to prove *reliance* on the omitted facts in making their decision to sell. The Court held that positive proof of such reliance was not necessary; all that was needed was to show that a reasonable seller might

have considered the non-disclosed facts important in making the decision to sell. *Id.* at 153.

From this, Petitioners argue that this Court eliminated any requirement for "proximate" or "loss" causation. This principle of law is not stated in *Affiliated Ute*, nor can it be derived from the language or the facts of that case. The issue of "loss causation" was not raised in *Affiliated Ute* and, accordingly, this Court was not called upon to address that issue.

Moreover, in *Affiliated Ute*, the fact that the omission actually caused the plaintiffs' monetary loss was obvious and unquestioned and the Court's decision is in no way contrary to the "loss causation" principle. The omitted facts were linked to the Indians' economic losses in a direct and meaningful way. The Indians were led to believe that they were being paid the market price for their stock when in fact the bank officers were secretly paying them less than market price and making a profit for themselves. In short, "if the facts were what [the investors] believed them to be" *i.e.*, if the price was the true market price, they would not have suffered a loss. Thus, there was "loss causation." *LHLC*, 842 F.2d at 931.

Consequently, *Affiliated Ute* has been consistently cited as a *reliance* case, not as a case establishing an all-encompassing standard for causation. *E.g.*, *Huddleston*, 640 F.2d at 547-48; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 381 (citing *Affiliated Ute* for the proposition that a plaintiff need not show actual reliance for "transaction causation," but still requiring "loss causation" as a separate element.) Correctly read, *Affiliated Ute* does not in any way relax or detract from the requirement that a plaintiff in a Rule 10b-5 case must plead and prove "proximate" or "loss" causation.

Finally, Petitioners rely on *dicta* in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986). However, that case does

not support Plaintiffs' position. *Randall* involved the sole question of whether an investor's damages under Section 12(2) and Rule 10b-5 are to be reduced by the value of tax benefits received by the investor from the investment. That issue is not presented in this case. Moreover, the Court's resolution, if anything, supports Defendants' position. This Court held that no such credit is to be given, relying on a number of reasons. Two of the reasons related to technical tax issues and are of no moment here. However, the third reason was the Court's conclusion that, under *common law principles*, tax benefits are not to be credited against damages in fraud cases. *Id.* at 658-59. Thus, this Court applied common law principles to the federal securities laws. *Randall*'s further observation that Congress expressly allowed for recovery under Section 12(2), notwithstanding that the decline in value was not actually caused by the misrepresentations, is irrelevant here—this case does not arise under Section 12(2). *See Harris Trust and Savings Bank v. Ellis*, 810 F.2d 706.

Of particular interest in *Randall* is the passage in which this Court states:

> We may therefore infer that Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure as well as to make investors whole. Indeed, by enabling the victim of prospectus fraud to demand rescission upon tender of the security, *Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud.*

Randall v. Loftsgaarden, 478 U.S. at 659 (emphasis added). This passage demonstrates that the risk of a decline in the value of an investment is ordinarily on the investor if the alleged fraud did not cause that decline. But, in Section 12(2), Congress expressly shifted the risk of such a loss to the seller of the security by allowing rescission upon

tender of the security. Significantly, Congress chose not to provide for any such shifting of risk in Section 10(b).

Finally, Petitioners' reliance on the Court's *dicta* in *Randall* that there is an open question as to whether rescission may be an appropriate *remedy* in Rule 10b-5 cases is inapposite for several reasons. First, rescission is a *measure* of damages which is relevant only *after* liability is determined. It is not a new standard for determining whether liability exists, nor a substitute for a necessary element of the underlying cause of action. In *Randall*, liability had already been determined before this Court addressed the rescission question. Likewise, in each of the cases cited by the Court in support of the proposition that the issue of rescission is an open question, the lower courts found liability first—then addressed the question of whether rescission was a proper remedy.

Moreover, even if rescission were otherwise available, it is irrelevant to Respondent McDermott, Will and Emery ("McDermott"). McDermott was not alleged to be the seller of the securities or otherwise in privity with Petitioners. McDermott was alleged simply to be the law firm for the sellers. Thus, there is nothing to rescind. Petitioners could not "return" the securities to McDermott and McDermott did not receive any of the purchase price to return to the Petitioners. *See Huddleston v. Herman & MacLean*, 640 F.2d at 555 (defendants cannot return the purchase price paid or rescind a transaction to which they were not a party).

For the same reason, Petitioners' related argument that they are entitled to recover "ill-gotten profits" also fails, at least as to McDermott. Even if there is such a principle (which is denied), Petitioners do not allege that McDermott made *any* profit on the sale of the securities to the Petitioners or anyone else, let alone "ill-gotten" profits.

B. "Loss Causation" Should Not Be Exempted From The Requirement Of Pre-Filing Investigations

Petitioners' contention that the Court should not require an allegation of "loss causation" because "it is often difficult for investors to make a pre-filing determination concerning the actual cause of the decline in their investments" deserves short shrift. In essence, Petitioners' claim that they should be excused from alleging an element of their claim so that they can initiate discovery to determine *if* they have such a claim. However, this is expressly prohibited by Rule 11 of the Federal Rules of Civil Procedure ("Rule 11") and the general rule that a plaintiff cannot file a claim without any basis solely to embark on a fishing expedition through discovery.

It is just this type of abuse that Rule 11 and the general pleading requirements are intended to prohibit. A party cannot make a claim unless it has a reasonable basis for believing that the claim is legitimate. This well founded rule should not be eviscerated by simply excusing a plaintiff from alleging an element of a claim. Indeed, taking Petitioners' argument to the logical extreme, this Court would be required to allow any plaintiff who can identify a wrong but cannot identify whether the wrong caused an injury to omit an allegation of causation and to proceed with discovery to determine whether there was causation. This Court should not put its imprimatur on such a result.

Similarly, Petitioners' suggestion that the burden of proving causation be shifted to defendants proves too much. If Petitioners' analysis is accepted, the same rationale would allow the shifting of this burden in all cases in which a plaintiff can identify wrongful conduct but does not know if it caused any harm. As in any cause of action, it is incumbent on the plaintiff to allege and prove that his or her harm was caused by the defendant; it is not the defen-

dant's burden to prove otherwise. Accordingly, "loss causation", like any element of a claim, must be alleged and proved in 10b-5 claims.

III.

Proximate Causation Or Its Equivalent Should Continue To Be A Necessary Element Of A RICO Claim

Section 1964(c) of RICO provides that a plaintiff has standing to sue for damages only if that person has been injured "by reason of" a defendant's violation of Section 1962. In *Haroco, Inc. v. American National Bank and Trust Co.*, 747 F.2d 384, 398 (7th Cir. 1984), *aff'd*, 473 U.S. 606 (1985), the Seventh Circuit held that this provision requires a showing of proximate cause:

> As we read this "by reason of" language, it simply imposes a *proximate cause* requirement on plaintiffs. (Emphasis added.)

Haroco was affirmed by this Court. Moreover, *Haroco*'s causation principle was stated again in the companion case of *Sedima, S/P.R.L. v. Imrex Co.*, 473 U.S. 479 (1985). In *Sedima*, the Court held:

> Conducting an enterprise that affects interstate commerce is obviously not in itself a violation of Section 1962, nor is mere commission of the predicate offenses. In addition, the plaintiff only has standing if, and can only recover to the extent that, he has been injured in his business or property *by the conduct constituting the violation.*
>
> * * *
>
> . . . the compensable injury necessarily is the harm *caused* by predicate acts . . .

Id. at 496, 497 (Emphasis added). Thus, to state a valid RICO claim, a plaintiff must allege that his or her injury was proximately caused by the defendant's commission of the predicate acts that constitute the RICO violation.

Petitioners nevertheless argue that *Sedima* supports their position that "proximate" or "loss" causation is not required, relying in great part on the *Sedima* Court's refusal to adopt a "racketeering injury" requirement in RICO cases because it would place requirements on questions relating to "standing" and "proximate cause" that were not intended by Congress. See *Sedima v. Imrex*, 473 U.S. at 498-99.

However, the discussion on which Petitioners rely offers no support to Petitioners' argument. This discussion from *Sedima* related only to the issue of whether a special "racketeering injury" similar to the type of "competitive injury" required under the anti-trust laws needed to be shown to recover under RICO, which the Court held did not. Thus, the "strict requirements on . . . 'proximate cause' " related only to the proposed, but rejected, requirement of "racketeering injury," not "proximate cause" generally. *Brandenburg v. Seidel*, 859 F.2d 1179, 1189 n.11 (4th Cir. 1988); *see also Sedima, S/P.R.L. v. Imrex Co.*, 473 U.S. at 497 n. 15.

Thus, it was a "RICO injury" requirement that this Court rejected in *Sedima*, not the requirement that a RICO plaintiff plead and prove that the predicate acts proximately caused his or her injury. As the Third Circuit states:

> The *Sedima* opinion makes plain that the injury which confers standing on a RICO plaintiff is injury flowing from commission of the predicate act, *not* injury flowing from the pattern of such acts.

Town of Kearny v. Hudson Meadows Urban Removal Corp., 829 F.2d 1263, 1268 (3d Cir. 1987) (emphasis added).

Indeed, after *Sedima*, "proximate cause" has been consistently required under RICO. *See, e.g., Marshall & Ilsley Trust Co. v. Pate*, 819 F.2d 806, 809 (7th Cir. 1987) (a

plaintiff must prove "an injury directly resulting from some or all of the activities comprising the violation"); *Zervas v. Faulkner*, 861 F.2d 823, 833-34 (5th Cir. 1988) (proximate cause is required); *Brandenburg v. Seidel*, 859 F.2d at 1187-90; *Sperber v. Boesky*, 849 F.2d 60, 64 (2nd Cir. 1988); *Seawell v. Miller Brewing Co.*, 576 F. Supp. 424, 430 (M.D. N.C. 1983) (no proximate cause sufficient to maintain RICO claim where intervening event, not the alleged predicate acts, was the cause of loss).

Where, as here, the alleged predicate act is not the proximate cause of the injury, a plaintiff lacks standing to sue. *Nodine v. Textron, Inc.*, 819 F.2d 347, 348-49 (1st Cir. 1987); *Morast v. Lance*, 807 F.2d 926, 932-33 (11th Cir. 1987). Where the injury which a plaintiff complains of was not proximately caused by the predicate acts, he does not have standing as a RICO plaintiff.

Finally, it must be remembered that the only predicate acts relied on by Petitioners to support their RICO injury are the claimed Rule 10b-5 violations. Thus, if the Court upholds the dismissal of Petitioners' Rule 10b-5 claims, their RICO claims must fall, without more. There simply would not be any predicate acts on which to base the purported RICO claim. *See Brannan v. Eisenstein*, 804 F.2d 1041, 1046 (8th Cir. 1986); *First Pacific Bancorp, Inc. v. Bro*, 847 F.2d 542, 546 (9th Cir. 1988); *In re Catanella and E.F. Hutton Securities Litigation*, 583 F.Supp. at 1425 (E.D.Pa. 1984) (if securities claim fails for lack of loss causation, that claim cannot serve as a predicate offense under RICO); *In re Gas Reclamation, Inc. Securities Litigation*, 663 F. Supp. 1123 (S.D.N.Y. 1987) (where securities claim failed for lack of causation, RICO claim based on same alleged violations failed also). Respondents are unaware of any case which permits a plaintiff to sue under RICO for predicate acts where, as here, *no one* has a direct cause of action for the predicate acts them-

selves. Indeed, there would be no justification for allowing such a suit.[11]

CONCLUSION

For the foregoing reasons, this Court should deny Petitioners' Petition for Certiorari.

Respectfully submitted,

STEPHEN NOVACK
(Counsel of Record)
DONALD A. TARKINGTON
NOVACK AND MACEY
303 West Madison Street
Suite 1500
Chicago, Illinois 60606
(312) 419-6900

Attorneys for Respondent
MCDERMOTT, WILL & EMERY

[11] We will not repeat all of the "policy" arguments set forth in Section 2 above; instead, they are incorporated by reference.

APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 86 C 2006

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M. T. DAVISSON,

Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; FAESTEL INVESTMENTS, INC., an Illinois corporation; DAVID J. FAESTEL; MC DERMOTT, WILL & EMERY, a partnership; and BRIAN HUCKER,

Defendants.

COMPLAINT

Introduction

1. This is an action to rescind or recover damages resulting from plaintiffs' investments in two Illinois oil and gas limited partnerships known as Petren Oil and Gas Program 1981A ("Petren 1981A") and Petren Oil and Gas Program 1981B ("Petren 1981B").

Jurisdiction And Venue

2. This Complaint arises under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. sec. 78a, *et seq.*,

under Section 17(a) of the Securities Act of 1933, 15 U.S.C. sec. 77a *et seq.*, and under Section 1962 of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. sec. 1961 *et seq.* Jurisdiction is conferred upon this Court by 28 U.S.C. sec. 1331, by Section 27 of the Exchange Act, 15 U.S.C. sec. 78aa, by Section 1964 of RICO, 18 U.S.C. sec. 1964, and by principles of pendent jurisdiction.

3. Venue within this District and Division is proper under 28 U.S.C. sec. 1391(b) and (c), under 15 U.S.C. sec. 78aa, and under 18 U.S.C. sec. 1965, in that all of the defendants have transacted their affairs and most of the unlawful acts and transactions alleged herein occurred in the Northern District of Illinois.

The Parties

4. Plaintiffs, R. Richard Bastian, III, B. P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CFM Associates, Alfred J. Hendron, Jr., and M. T. Davisson, purchased limited partnership interests in one or more of the Petren Oil and Gas Programs.

5. Defendant, Petren Resourses Corporation ("Petren"), is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. Petren is a co-general partner in both Petren Oil and Gas Programs.

6. Defendant, Faestel Investments, Inc. ("FII"), is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. FII is a co-general partner in both Petren Oil and Gas Programs.

7. Defendant, David J. Faestel ("Faestel"), is an officer, director and sole shareholder of FII and the Chairman of the Board and principal shareholder of Petren.

8. Defendant, McDermott, Will & Emery ("MWE"), is an Illinois partnership which is engaged in the practice of law. MWE's principal office is located in Chicago, Illinois.

9. Defendant, Brian S. Hucker ("Hucker"), is an attorney and partner with MWE.

Description Of Petren Oil And Gas Programs

10. Petren 1981A and Petren 1981B were formed to explore and drill for oil and gas. Petren 1981A was formed in or about May, 1981, and Petren 1981B was formed in or about September 1981.

11. In order to raise the funds necessary to explore and drill for oil and gas, Petren, FII and Faestel sold limited partnership interests in Petren 1981A and Petren 1981B.

12. In connection with their sales and solicitation efforts, Petren, FII and Faestel employed Hucker and MWE to prepare an "Offering Memorandum" for each of the Petren 1981A and Petren 1981B limited partnerships.

13. The Offering Memoranda which Hucker and MWE prepared were distributed to each of the investors in the limited partnerships prior to the time they made their investments.

14. The Offering Memoranda which Hucker and MWE prepared are in excess of 95 pages in length and are substantially similar. The Offering Memoranda purport to disclose all material information about the limited partnerships, including material information about the two general partners and their principals.

15. Each Offering Memorandum identifies MWE as counsel for the partnership.

16. Each Offering Memorandum describes Faestel, FII and Petren as being qualified and experienced in oil and gas ventures.

17. Each of the plaintiffs received and reviewed a copy of the Offering Memorandum prior to making their investment in the Petren Oil and Gas Programs.

Non-Disclosures In The Offering Memoranda

18. Each Offering Memorandum failed to disclose the following facts about the qualifications and prior experience of Faestel, FII and Petren:

(a) That in or about September, 1979, Faestel and FII were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and FII had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior oil and gas ventures they had promoted; and

(c) That Petren was established by Faestel and FII solely to promote the Petren Oil and Gas Programs and that Petren was, in actuality, nothing more than the alter ego of Faestel and FII.

19. Each of the foregoing facts were known by the defendants at the time the Offering Memoranda were prepared and distributed to investors. MWE and Hucker represented Faestel and FII in the securities litigation de-

scribed in paragraph 18(a) above, and, on information and belief, represented them in connection with the loans they obtained from the Northern Trust and in the formation of Petren.

20. Each of the facts described in paragraph 18 above were material and should have been disclosed in the Offering Memoranda which were distributed to investors, in order to make the Offering Memoranda not misleading.

21. After receiving and reviewing the Offering Memoranda, plaintiffs invested in one or more of the Petren Oil and Gas Programs as follows:

Name	*Amount Invested*	*Program*
Ronald & Marcia Rotunda	$ 50,000	Petren 1981B
B. P. Loughridge, M.D.	100,000	Petren 1981B
R. Richard Bastian, III	50,000	Petren 1981A
General Synergy Investments	100,000	Petren 1981B
Gabriel Fernandez	25,000	Petren 1981A
J. Mahar	25,000	Petren 1981A
CFM Associates	100,000	Petren 1981B
Alfred J. Hendron, Jr.	25,000	Petren 1981A
	50,000	Petren 1981B
M. T. Davisson	25,000	Petren 1981A
	50,000	Petren 1981B
Total Invested By Plaintiffs:	$600,000	

Discovery Of The Non-Disclosures

22. No plaintiff was aware of the facts described in paragraph 18 at the time they made their investments. Moreover, as a result of affirmative representations and statements contained in the Offering Memoranda, no plain-

tiff had any reason to suspect that the information contained in the Offering Memoranda was incomplete, misleading or otherwise untrue.

23. In late April, 1984, plaintiff Ronald B. Rotunda became concerned about his investment in Petren 1981B when he was informed by the general partners that the 1983 Petren 1981B financial statement would not be audited as had been represented in the Offering Memorandum. Rotunda's concern was further heightened when he contacted Hucker and other attorneys at MWE about the financial statement and was informed that MWE did not represent the Petren Oil and Gas partnerships but, rather, represented only the general partners.

24. Thereafter, Rotunda retained an attorney to investigate his investment. During the course of his investigation, Rotunda's attorney was told by Hucker that no other limited partners were questioning the conduct of Faestel or the general partners. Hucker's statement was not true and was made in order to lull Rotunda's attorney into a false sense of security. Contrary to Hucker's representations, at the time Rotunda's attorney was conducting his investigation, there were at least two separate federal actions filed against Faestel and the general partners relating to the Petren Oil and Gas Programs.

25. After learning of the pendency of the federal lawsuits against Faestel and the general partners, Rotunda's counsel, in or about September, 1984, conducted a search of court records in Cook County, Illinois, and discovered that Faestel and FII had been sued in 1979 for violations of the federal and state securities laws and that Northern Trust had filed suit against them on defaulted loans. This was the first time any of the plaintiffs had any knowledge that Faestel and FII had previously been sued

for securities laws violations or that, at the time they were promoting the Petren Oil and Gas Programs, they were in default on substantial loans.

26. By the time Rotunda's counsel discovered the non-disclosed facts described above, plaintiffs' investments in the Petren Oil and Gas Programs had become worthless.

COUNT I

ACTION FOR DEFENDANTS' VIOLATIONS OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND SEC RULE 10b-5

1. This action arises under Section 10(b) of the Securities Exchange Act, 15 U.S.C. sec. 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. sec. 240.10b-5.

2-27. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count I.

28. The Petren 1981A and Petren 1981B limited partnership interests which plaintiffs purchased are securities within the meaning of Section 3(a)(10) of the Securities Exchange Act, (15 U.S.C. sec. 78c(a)(10).

29. The Petren 1981A and Petren 1981B limited partnership interests which were sold to plaintiffs were sold through means and instrumentalities of interstate commerce.

30. The facts which defendants omitted to include in the Offering Memoranda were material, in that there is a substantial likelihood that plaintiffs would have considered them important in making their investment decision.

31. The omissions described above were made in connection with the sale to plaintiffs of limited partnership

interests in the Petren 1981A and Petren 1981B limited partnerships.

32. Each of the defendants had a duty to disclose the omitted facts. Alternatively, each defendant aided and abetted the other defendants in the breach of their duty to disclose the omitted facts.

33. In failing to disclose the omitted facts, or in aiding and abetting such non-disclosure, each defendant acted either with the intent to defraud or with recklessness.

34. By their failure, as described above, to disclose material facts, defendants violated Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Rescind plaintiffs' purchase of limited partnership interests in Petren 1981A and Petren 1981B and require defendants to refund the full amount of their investment plus interest from the date of the investment;

B. Alternatively, enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the court may deem just and appropriate.

COUNT II

ACTION FOR DEFENDANTS' VIOLATIONS OF SECTION 17(a) OF THE SECURITIES ACT OF 1933

1. This action arises under Section 17(a) of the Securities Act of 1933, 15 U.S.C. sec. 77q(a).

2-27. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count II.

28. The Petren 1981A and Petren 1981B limited partnership interests which plaintiffs purchased are securities within the meaning of Section 2(1) of the Securities Act of 1933, 15 U.S.C. sec. 77b(1).

29-32. Plaintiffs incorporate and reallege the allegations of paragraphs 29 through 32 of Count I as paragraphs 29 through 32 of this Count II.

33. In failing to disclose the omitted facts, or in aiding and abetting such non-disclosure, each defendant acted either negligently, with the intent to defraud, or with recklessness.

34. By their failure, as described above, to disclose material facts, defendants violated Section 17(a) of the Securities Act of 1933, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Rescind plaintiffs' purchase of limited partnership interests in Petren 1981A and Petren 1981B and require defendants to refund the full amount of their investment plus interest from the date of the investment;

B. Alternatively, enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the court may deem just and appropriate.

COUNT III

ACTION FOR DEFENDANTS' VIOLATIONS OF THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1. This action arises under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. sec. 1961, *et seq.* ("RICO").

2-27. Plaintiffs incorporate and reallege the allegations of paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count III.

28-34. Plaintiffs incorporate and reallege the allegations of paragraphs 28 through 34 of Count I, which describe defendants' violations of Section 10(b) and SEC Rule 10b-5, as paragraphs 28 through 34 of this Count III.

35-41. Plaintiffs incorporate and reallege the allegations of paragraphs 28 through 34 of Count II, which describe defendants' violations of Section 17(a) of the Securities Act of 1933, as paragraphs 35 through 41 of this Count III.

42. Petren 1981A and Petren 1981B are enterprises engaged in and whose activities affect interstate and foreign commerce.

43. Each defendant was employed by or associated with Petren 1981A and Petren 1981B at the time the acts complained of herein occurred.

44. Each defendant conducted and participated, either directly or indirectly, in the conduct of Petren 1981A's and Petren 1981B's affairs through a pattern of racketeering activity, in violation of 18 U.S.C. sec. 1962(c).

45. Each defendant combined, conspired and agreed to conduct the affairs of Petren 1981A and Petren 1981B through a pattern of racketeering activity in violation of 18 U.S.C. sec. 1962(d).

46. The pattern of racketeering activity through which the defendants conducted and participated in the affairs of Petren 1981A and Petren 1981B involved each of the following prohibited acts:

(a) Fraud in connection with the sale to plaintiffs of Petren 1981A limited partnership interests, in violation of Section 10(b) and SEC Rule 10b-5;

(b) Fraud in connection with the sale to plaintiffs of Petren 1981A limited partnership interests, in violation of Section 17(a) of the Securities Act of 1933;

(c) Fraud in connection with the sale to plaintiffs of Petren 1981B limited partnership interests, in violation of Section 10(b) and SEC Rule 10b-5; and

(d) Fraud in connection with the sale to plaintiffs of Petren 1981B limited partnership interests, in violation of Section 17(a) of the Securities Act of 1933.

47. All of the acts of racketeering activity hereinabove alleged occurred after the effective date of RICO and all occurred within ten years of a prior act.

48. Plaintiffs have been injured in their business and property by reason of the defendants' violations of 18 U.S.C. sec. 1962(c) and (d).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(c) and (d);

B. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT IV

ACTION FOR DEFENDANTS' VIOLATIONS OF THE ILLINOIS CONSUMER FRAUD AND DECEPTIVE PRACTICES ACT

1. This action arises under the Illinois Consumer Fraud and Deceptive Business Practices Act ("Illinois Consumer Fraud Act"), ILL. REV. STAT., ch. 121½, sec. 261, *et seq.*

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count IV.

29. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, defendants acted wilfully and wantonly and with the intent that plaintiffs and other investors rely upon the concealment or omission of such material facts.

30. By their failure, as described above, to disclose material facts in connection with the sale to plaintiffs of

limited partnership interests in Petren 1981A and Petren 1981B, defendants violated Section 2 of the Illinois Consumer Fraud Act, ILL. REV. STAT., ch. 121½, sec. 262, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT V

ACTION FOR BREACH OF DEFENDANTS' FIDUCIARY DUTIES

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count V.

29. By reason of their status as general partners of Petren 1981A and Petren 1981B, defendants Petren and FII stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

30. By reason of their status as counsel to Petren 1981A and Petren 1981B, Hucker and MWE stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

31. By reason of their failure to disclose material facts in connection with the sale of limited partnership interests, defendants Petren, FII, Hucker and MWE breached their fiduciary duties, causing damage to plaintiffs.

32. As a result of his actions and inactions, defendant Faestel participated in, and aided and abetted Petren, FII, Hucker and MWE in, the breach of their fiduciary duties to plaintiffs.

33. As a result of their actions and inactions, Hucker and MWE participated in, and aided and abetted Petren and FII in, the breach of their fiduciary duties to plaintiffs.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted wilfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a

result of defendants' breach of their fiduciary duties, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT VI

ACTION FOR COMMON LAW FRAUD

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count VI.

29. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted wilfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

30. As a consequence of defendants' non-disclosure and omissions, plaintiffs were cheated and defrauded and were damaged thereby.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a

result of defendants' fraud, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT VII

ACTION FOR NEGLIGENCE AGAINST MWE AND HUCKER

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count VII.

29. MWE and Hucker, as counsel for Petren 1981A and Petren 1981B, and as the attorneys responsible for the preparation of the Petren 1981A and Petren 1981B Offering Memoranda, had an affirmative duty to independently verify the disclosures made in the Offering Memoranda and ensure full disclosure of all material facts.

30. Plaintiffs were the intended or reasonably foreseeable beneficiaries of MWE's and Hucker's work product, and it was foreseeable that plaintiffs would rely upon the Offering Memoranda that MWE and Hucker prepared.

31. By failing to discover and/or disclose the material facts described above, defendants MWE and Hucker negligently failed to perform their duty to independently verify the disclosures made in the Offering Memoranda and to ensure full disclosure of all material facts, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants MWE and Hucker for the amount of damages sustained as a result of defendants' negligence, along with prejudgment interest as the law may allow;

B. Award plaintiffs, and order defendants to pay, the full cost of this action; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M.T. DAVISSON

By: ______________________________

One of Their Attorneys

Michael H. Moirano
Michael H. Moirano, Ltd.
175 North Franklin Street
Suite 401
Chicago, Illinois 60606
(312) 641-3245

Corrected Copy

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 86 C 2006
Hon. Brian Barnett Duff

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M. T. DAVISSON,

Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; FAESTEL INVESTMENTS, INC., an Illinois corporation; DAVID J. FAESTEL, and MC DERMOTT, WILL & EMERY, a partnership,

Defendants.

AMENDED COMPLAINT

Introduction

1. This is an action to rescind or recover damages resulting from plaintiffs' investments in two Illinois oil and gas limited partnerships knows as Petren Oil and Gas Program 1981A ("Petren 1981A") and Petren Oil and Gas Program 1981B ("Petren 1981B"). Plaintiffs were fraudulently induced to make their investments and now seek to recover the full amount of their investment plus interest.

Jurisdiction and Venue

2. Jurisdiction is conferred upon this Court by 28 U.S.C. §1331, by §1964 of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1964, and by principles of pendent jurisdiction.

3. Venue within this District and Division is proper under 28 U.S.C. §1391(b) and (c) and under 18 U.S.C. §1965, in that all of the defendants have transacted their affairs and most of the unlawful acts and transactions alleged herein occurred in the Northern District of Illinois.

The Parties

4. Plaintiffs R. Richard Bastian, III, B. P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CMF Associates, Alfred J. Hendron, Jr. and M. T. Davisson each purchased limited partnership interests in one or more of the Petren Oil and Gas limited partnerships.

5. Defendant Petren Resources Corporation ("Petren") is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. Petren is a co-general partner in both Petren Oil and Gas limited partnerships.

6. Defendant Faestel Investments, Inc. ("FII") is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. FII is a co-general partner in both Petren Oil and Gas limited partnerships.

7. Defendant David J. Faestel ("Faestel") is an officer, director and sole shareholder of FII and the chairman and principal shareholder of Petren.

8. Defendant Mc Dermott, Will & Emery ("MWE") is an Illinois partnership which is engaged in the practice of law. MWE's principal office is located in Chicago, Illinois.

Description of the Petren Oil and Gas limited partnerships

9. Petren 1981A and Petren 1981B limited partnerships were formed to explore and drill for oil and gas. Petren 1981A was formed in or about May, 1981, and Petren 1981B was formed in or about September, 1981.

10. In order to raise the funds necessary to explore and drill for oil and gas, Petren, FII and Faestel sold limited partnership interests in Petren 1981A and Petren 1981B.

11. In connection with their sales and solicitation efforts, Petren, FII and Faestel employed MWE to prepare an "Offering Memorandum" for each of the limited partnerships.

12. The Offering Memoranda which MWE prepared were distributed to each of the plaintiffs in the limited partnerships prior to the time they made their investments.

13. The Offering Memoranda which MWE prepared are each in excess of 95 pages in length and are substantially similar. The Offering Memoranda purport to disclose material information about the limited partnerships, including material information about the qualifications, experience and abilities of the two general partners and their principals.

14. Each Offering Memorandum identifies MWE as counsel for the partnership.

15. Each Offering Memorandum describes Faestel, FII and Petren as being qualified and experienced in oil and gas programs.

16. Each of the plaintiffs received and reviewed a copy of the Offering Memorandum prior to making their investment in the Petren Oil and Gas limited partnerships.

Non-Disclosures In The Offering Memoranda

17. Each Offering Memorandum failed to disclose the following facts about the qualifications and prior experience of Faestel, FII and Petren:

(a) That in or about September 4, 1979, Faestel and FII were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and FII had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior ventures they had promoted; and

(c) That Petren was established by Faestel and FII solely to promote the Petren Oil and Gas limited partnerships and had no previous operating history or experience and an insubstantial net worth; and

(d) That Petren was, in actuality, nothing more than the alter ego of Faestel and FII.

18. Each of the foregoing facts were either known by the defendants at the time the Offering Memoranda were prepared and distributed to investors or, upon diligent inquiry, should have been known by the Defendants.

19. Each of the facts described in paragraph 18 above were material and should been disclosed in the Offering Memoranda which were distributed to investors in order to make the Offering Memoranda not misleading.

20. Had the facts described in paragraph 18 above been disclosed in the Offering Memoranda the limited partnership interests being offered would have been unmarketable.

21. After receiving and reviewing the Offering Memoranda, plaintiffs invested in one or more of the Petren Oil and Gas limited partnerships as follows:

Name	*Amount Invested*	*Program*
Ronald & Marcia Rotunda	$ 50,000	Petren 1981B
B. P. Loughridge, M.D.	100,000	Petren 1981B
R. Richard Bastian, III	50,000	Petren 1981A
General Synergy Investments	100,000	Petren 1981B
Gabriel Fernandez	25,000	Petren 1981A
J. Mahar	25,000	Petren 1981A
CFM Associates	100,000	Petren 1981B
Alfred J. Hendron, Jr.	25,000	Petren 1981A
	50,000	Petren 1981B
M. T. Davisson	25,000	Petren 1981A
	50,000	Petren 1981B
Total Invested By Plaintiffs:	$600,000	

22. Had the facts described in paragraph 18 above been disclosed in the Offering Memoranda distributed to the Plaintiffs, none of the plaintiffs would have invested any money in either Petren limited partnership.

23. No plaintiff was aware of the facts described in paragraph 18 at the time they made their investments.

Moreover, as a result of affirmative representations and statements contained in the Offering Memoranda, no plaintiff had any reason to suspect that the information contained in the Offering Memoranda was incomplete, misleading or otherwise untrue.

24. In late April, 1984, plaintiff Ronald B. Rutunda became concerned about his investment in Petren 1981B when he was informed by the general partners that the 1983 Petren 1981B financial statement would not be audited as had been represented in the Offering Memorandum. Rotunda's concern was further heightened when he contacted Brian Hucker ("Hucker"), a partner at MWE, about the financial statement and was informed that, contrary to statements made in the Offering Memoranda, MWE did not represent the Petren Oil and Gas partnerships but, rather, represented only the general partners.

25. Thereafter, Rotunda retained an attorney to investigate his investment. During the course of this investigation, Rotunda's attorney was told by Hucker that no other limited partners were questioning the conduct of Faestel or the general partners. Hucker's statement was not true and was made in order to lull Rotunda's attorney into a false sense of security. Contrary to Hucker's representations, at the time Rotunda's attorney was conducting his investigation, there were at least two separate federal actions filed against Faestel and the general partners relating the Petren Oil and Gas limited partnerships.

26. After learning of the pendency of the federal lawsuits against Faestel and the general partners, Rotunda's counsel, in or about September, 1984, conducted a search of court records in Cook County, Illinois, and discovered that Faestel and FII had been sued in 1979 for violations of the federal and state securities laws and that North-

ern Trust had filed suit against them on the defaulted loans. This was the first time any of the plaintiffs had any knowledge that Faestel and FII had previously been sued for securities laws violations or that, at the time they were promoting the Petren Oil and Gas Programs, they were in default on substantial loans.

27. By the time Rotunda's counsel discoverd the non-disclosed facts described above, plaintiff's investments in the Petren Oil and Gas limited partnerships had become worthless.

COUNT I

ACTION FOR VIOLATIONS OF SECTION 1962(C) OF THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1-27. Plaintiffs incorporate and reallege the allegations of paragraphs 1 through 27 of the Amended Complaint as paragraphs 1 through 27 of this Count I.

28. This action arises under Section 1962(c) of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(c), and is brought against defendants Faestel, FII and MWE only.

30. Petren is an enterprise engaged in and whose activities affect interstate and foreign commerce.

31. Each defendant was employed by or associated with Petren at the time the acts complained of herein occurred.

32. Each defendant conducted and participated, either directly or indirectly, in the conduct of Petren affairs through a pattern of racketeering activity, in violation of 18 U.S.C. §1962(c).

33. Each defendant combined, conspired and agreed to conduct the affairs of Petren through a pattern of racketeering activity in violation of 18 U.S.C. §1962(d).

34. The pattern of racketeering activity through which the defendants conducted and participated in the affairs of Petren extended over a twenty month period and involved numerous and repeated acts of securities fraud generally described as follows:

(a) From March, 1981, through October, 1982, the defendants participated in and promoted five separate and distinct limited partnerships. In each instance, Petren either acted as the managing general partner or held a substantial interest in the managing general partner. During this period, and thereafter, Petren derived most, if not all, of its income from the various limited partnerships.

(b) The five limited partnerships, were as follows:

Petren 1981A—March, 1981 (Petren was managing general partner);

Petren 1981B—June, 1981 (Petren was managing general partner);

Petren Drilling Rig Limited—1981 (Petren 1981 Drilling)—November, 1981 (Petren owned 50% interest in managing general partner);

Petren 1982A Oil and Gas Program (Petren 1982A)—May, 1982 (Petren was managing general partner).

Petren 1982B Oil and Gas Program (Petren 1982B); October, 1982 (Petren managing general partner).

(c) In connection with each limited partnership, Faestel, FII or persons acting on their behalf offered and sold limited partnership interests to various investors.

Each of the limited partnership interests sold were securities within the meaning of Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. §78c(a)(10), and Section 2(1) of the Securities Act of 1933, 15 U.S.C. §77b(1), and were sold through means and instrumentalities of interstate commerce;

(d) In connection with the sale of the limited partnership interests, one or more of the defendants prepared and distributed to prospective investors Offering Memoranda which contained material misrepresentations and/or omitted to include material facts. Specifically:

(i) In connection with the Petren 1981A offering defendants Faestel, FII and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the material facts described in paragraph 17 above.

(ii) In connection with the Petren 1981B offering defendants Faestel, FII and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17 above.

(iii) In connection with the Petren 1981 Drilling offering defendants Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17 above. In addition, in the Offering Memoranda, said defendants specifically represented that Faestel had made detailed representations to MWE as to his personal net worth and liquidity and that nothing had come to the attention of MWE which would cause them to question the validity of Mr. Faestel's

representations. In fact, at the time the Offering Memoranda were prepared, Faestel and MWE knew that Faestel was, and had been, in default on substantial loans from the Northern Trust and was experiencing extreme financial difficulties.

(iv) In connection with the Petren 1982A offering, defendants Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17, above, and which also failed to disclose that shortly before the offering, Petren had terminated its president and chief petroleum engineer for incompetence and recklessness in analyzing and recommending oil and gas prospects for the Petren 1981A and Petren 1981B limited partnerships. In addition, in the Petren 1982A Offering Memoranda, the defendants falsely represented that the Petren 1981A and Petren 1981B limited partnerships were each anticipating substantial future income and a significant return on investment when, at that time, these defendants knew that those limited partnerships had little or no chance to realize any substantial income or return on investment.

(v) In connection with the Petren 1982B offering, Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraphs 17 and 34(d)(iv) above, and which also failed to disclose that, at that time, both Faestel and FII were in default on numerous loans in addition to the Northern Trust loans and were essentially insolvent. In addition, in the Petren 1982B Offering

Memoranda, Faestel and MWE also again misrepresented the potential earnings and return on investment of the Petren 1981A and Petren 1981B limited partnerships, claiming falsely that those partnerships could expect substantial income and return on investment.

(d) In making the misrepresentations and/or failing to disclose the omitted facts described above, each defendant acted either with the intent to defraud or recklessly.

(e) By preparing and circulating false and misleading Offering Memoranda in connection with the sale of limited partnership interests described above, the defendants, in each instance, violated Section 10(b) of the Securities Exchange Act and §Rule 10b-5, and Section 17(a) of the Securities Act of 1933.

35. Plaintiffs have been injured in their business and property by reason of the defendant's violations of 18 U.S.C. sec. 1962(c) and (d).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants Faestel, FII and MWE for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(c) and (d);

B. Award plaintiffs, and order said defendants to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT II

ACTION FOR VIOLATIONS OF SECTION 1962(a) OF THE RACKATEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1-27. Plaintiffs incorporate and reallege the allegations or paragraphs 1 through 27 of the Amended Complaint as paragraphs 1 through 27 of this Count II.

28. This action arises under Section 1962(a) of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(a), and is brought against defendant Petren only.

29. Plaintiffs incorporate and reallege the allegations of paragraph 34(a) through (e) of Count I, which described the pattern of racketeering activity involved in this case, as paragraph 29 of this Count II.

30. Defendant Petren has received income derived directly or indirectly from the pattern of racketeering activity described in paragraph 29 above.

31. Defendant Petren is an enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

32. Defendant Petren has used, directly or indirectly, the income it received from the pattern of racketeering activity described above in the establishment and operation of its affairs, in violation of 18 U.S.C. §1962(a).

33. Plaintiffs have been injured in their business and property by reason of Petren's violation of 18 U.S.C. §1962(a).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendant Petren for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(a);

B. Award plaintiffs, and order said defendant to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT III

ACTION FOR DEFENDANTS' VIOLATIONS OF THE ILLINOIS CONSUMER FRAUD AND DECEPTIVE PRACTICES ACT

1. This action arises under the Illinois Consumer Fraud and Deceptive Business Practices Act ("Illinois Consumer Fraud Act"), Ill. Rev. Stat., ch. 121½, §261, *et seq.*

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count III.

30. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, defendants acted either negligently, recklessly or willfully and wantonly.

31. By their failure, as descibed above, to disclose material facts in connection with the sale to plaintiffs of limited partnership interests in Petren 1981A and Petren 1981B, defendants violated Section 2 of the Illinois Consumer Fraud Act, Ill. Rev. Stat., ch. 121½, §262, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT IV

ACTION FOR BREACH OF DEFENDANTS' FIDUCIARY DUTIES

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count IV.

30. By reason of their status as general partners of Petren 1981A and Petren 1981B, defendants Petren and FII stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

31. By reason of its status as counsel to Petren 1981A and Petren 1981B, Defendant MWE stood in a fiduciary relationship to the limited partners and was obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

32. By reason of their failure to disclose material facts in connection with the sale of the limited partnership interests, defendants Petren, FII, and MWE breached their fiduciary duties, causing damage to plaintiffs.

33. As a result of its actions and inactions, MWE participated in and aided and abetted Petren and FII in the breach of their fiduciary duties to plaintiffs.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted willfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' breach of their fiduciary duties, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT V

ACTION FOR COMMON LAW FRAUD

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count V.

30. The Offering Memoranda prepared by defendants were distributed to plaintiffs with the intent to induce plaintiffs to invest in the limited partnerships.

31. Plaintiff invested in the limited partnerships in reliance on the truth and accuracy of the information contained in the Offering Memoranda.

32. Plaintiffs reliance on the truthfulness and accuracy of the Offering Memoranda was reasonable under the circumstances.

33. The Offering Memoranda were false and misleading due to the non-disclosures of the material facts described above.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted willfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

35. By reason of their failure to disclose the material facts described above, defendants cheated and defrauded the plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' fraud, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

COUNT VI

ACTION FOR NEGLIGENCE AGAINST MWE

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Complaint as paragraphs 3 through 29 of this Count VI.

30. MWE as counsel for Petren 1981A and Petren 1981B, and as the attorneys responsible for the preparation of the Petren 1981A and Petren 1981B Offering Memoranda, had an affirmative duty to independently verify the disclosures made in the Offering Memoranda and ensure full disclosure of all material facts.

31. Plaintiffs were the intended or reasonably foreseeable beneficiaries of MWE's work product, and it was

foreseeable that plaintiffs would rely upon the Offering Memoranda that MWE prepared.

32. By failing to discover and/or disclose the material facts described above, defendant MWE negligently failed to perform its duty to independently verify the disclosures made in the Offering Memoranda and to ensure full disclosure of all material facts, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendant MWE for the amount of damages sustained as a result of defendant's negligence, along with prejudgment interest as the law may allow;

B. Award plaintiffs, and order said defendant to pay, the full cost of this action; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M.T. DAVISSON

By: ______________________________

One of Their Attorneys

Michael H. Moirano
Shelly B. Kulwin
11 South LaSalle Street
Suite 1000
Chicago, Illinois 60606
(312) 419-0100
(312) 641-0300

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 88-3299

R. RICHARD BASTIAN, III, B. P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR. and M. T. DAVISSON,

Plaintiffs-Appellants,

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a partnership,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 86 C 2006
Honorable Brian Barnett Duff, Presiding Judge

PLAINTIFFS' RESPONSE TO DEFENDANTS' MOTION TO DISMISS PORTION OF APPEAL AND TO STAY BRIEFING PENDING RULING

INTRODUCTION

Defendants seek to dismiss plaintiffs' appeal from an order entered March 7, 1988, dismissing plaintiffs' claims under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78j(b). Defendants contend that plain-

tiffs "waived" their right to appeal this order by failing to reallege the dismissed claims in an amended complaint plaintiffs subsequently filed.

In making their waiver argument, defendants neglect to point out several relevant facts concerning the circumstances surrounding the dismissal and plaintiffs' ability to replead. They also fail to discuss the significant body of precedent which specifically rejects the waiver rule they propose. Finally, they offer no rationale for a mechanical application of the waiver rule. Instead, they simply suggest that this Court blindly follow the lead of the Ninth Circuit, which is the only court to have recognized and applied the rule.

FACTS NOT DISCUSSED

Defendants would have this Court believe that plaintiffs were not interested in preserving their right to appeal the dismissal of their Section 10(b) claims and, therefore, intentionally failed to include these claims in their amended complaint. Nothing could be further from the truth.

Plaintiffs' Section 10(b) claims were dismissed because plaintiffs failed to allege "loss causation." *Bastian v. Petren Resources Corporation*, 681 F.Supp. 530, 534 (N.D. Ill. 1988) ("Bastian I"). Loss causation is pleading requirement recently imposed by some courts in Section 10(b) actions which requires the plaintiff to allege and prove that the defendant's misrepresentations and omissions actually "caused" the subsequent decline in the value of the plaintiffs' investments. This Court has twice rejected this causation requirement, most recently in *Rankow v. First Chicago Corporation*, No. 88-1405, Slip Op. at pp. 22-23

(7th Cir. February 24, 1989). *See also LHLC Corporation v. Cluett, Peabody & Company, Inc.*, 842 F.2d 928 (7th Cir.) *cert. denied,* 109 S.Ct. 311 (1988).[1]

What defendants fail to point out is that when Judge Duff allowed plaintiffs leave to amend their Section 10(b) claims, he also threatened to impose sanctions if they did so and failed to include allegations establishing "loss causation." *Bastian I,* 681 F.Supp. at 536. Plaintiffs, who are merely limited partner investors with no access to partnership information other than that supplied by the defendant general partner, were in no position to allege what "caused the subsequent decline in the value of their investment," particularly in the face of Judge Duff's threat of sanctions. It was for this reason that plaintiffs did not attempt to reallege their Section 10(b) claims.

What Plaintiffs did do (although defendants again fail to mention it), was file a motion to certify Judge Duff's ruling for interlocutory appeal pursuant to 28 U.S.C. Sec. 1292(b). But that motion was denied. *Bastian v. Petren Resources Corporation,* 682 F.Supp. 956, 957 (N.D. Ill. 1988). Thus, plaintiffs were left in a position where they could not appeal the dismissal of their Section 10(b) claims until a final judgment was entered. Refiling the same claims and being subjected to possible sanctions would not have helped the situation. Any suggestion that under these circumstances plaintiffs "deliberately" waived their right to appeal is simply contrary to the facts.

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1 Defendants' belated motion to dismiss this appeal (filed almost four months after the filing of Notice of Appeal and *after* they obtained an extension of time to file their brief), was most likely prompted by the recent and dispositive *Rankow* decision. Defendants offer no other explanation for the delay in raising their waiver argument.

THERE IS A SUBSTANTIAL BODY OF LAW WHICH IS DIRECTLY CONTRARY TO DEFENDANTS' "WAIVER ARGUMENT"

Not only is defendants' "waiver" argument unsupported by the facts, it is contrary to most case law and conflicts with the views of the commentators. Only the Ninth Circuit has adopted a waiver rule and even some members of that Court are questioning the rule's continuing validity. *See London v. Coopers & Lybrand*, 644 F.2d 811, 814 (9th Cir. 1981) (stating "we are well aware that other Circuits do not look with favor upon this [waiver] rule, . . . but we as a panel are not at liberty to re-examine its validity.")[2]

Most courts which have considered the waiver rule have flatly rejected it. See, for example:

* *Williamson v. Liverpool & London & Globe Insurance Co.*, 141 F. 54, 57 (8th Cir. 1905)
* *Blazer v. Black*, 196 F.2d 139, 143-44 (10th Cir. 1952) (holding that "while the pleader who amends or pleads over waives his objections to the ruling of the court on indefiniteness, incompleteness or insufficiency, or mere technical defects in pleadings, he does not waive his exception to the ruling which strike 'a vital blow to a substantial part' of his cause of action.")
* *Wilson v. First Houston Investment*, 566 F.2d 1235, 1237-38 (5th Cir. 1978) (holding that a plaintiff, who filed an amended complaint after a dis-

[2] Defendants claim in their memorandum that the Tenth Circuit in *Legett v. Montgomery Ward & Co.*, 178 F.2d 436 (10th Cir. 1949), and the Sixth Circuit in *Grubs v. Smith*, 86 F.2d 275 (6th Cir.) *cert. denied*, 300 U.S. 658 (1936), also adopted a waiver rule similar to that proposed by defendants, but a careful reading of those decisions shows they did not.

missal with leave to amend, was not barred from raising on appeal the correctness of the dismissal order.)

The "waiver" rule adopted by the Ninth Circuit was most recently criticized in *United States v. Bonanno Organized Crime Family*, 695 F.Supp. 1426, 1433 (S.D.N.Y. 1988) where the court called the rule "questionable." Other criticism of the rule can be found in G. C. Wright and A. Miller, *Federal Practice & Procedure*, Section 1476 at 393-4 (1971) and in 3 J. Moore, Moore's Federal Practice, para. 15.08[8] at 15-97 (2d Ed. 1987). As Wright & Miller explain:

> A rule that a party waives his objections to the court's dismissal if he elects to amend is too mechanical and seeks to be a rigid application of the concept that a Rule 15(a) amendment completely replaces the pleading it amends. Without more, the action of the amending party should not result in completely denying him the right to appeal the court's ruling. By way of contrast, if the motion to dismiss is denied and defendant answers the denial of his motion to dismiss on an appeal from the ultimate judgment. Similar principles apply to plaintiff when he unsuccessfully moves to strike a defense as legally insufficient and later serves a reply by order of the court. It therefore is not logical to deny a party the right to appeal simply because he decides to abide by the court's order and amend his pleading rather than allowing judgment to be entered against him and taking an immediate appeal."

Id. Professor Moore's views are to the same effect.

As these commentators recognize, a rule which requires a party to replead a dismissed claim makes little sense. Once the dismissed claim is realleged, some action must be taken. The claim must either must be answered or dismissed again. *Bienmau v. City of Chicago*, 662 F.Supp.

1297, 1299 (N.D. Ill. 1987). This procedure only creates additional work for the district court and serves no particular purpose.

Moreover, neither the Ninth Circuit nor the defendants have ever attempted to explain how the waiver rule comports with the provisions of Fed.R.Civ.P. 54(b). Rule 54(b) permits a court to direct the entry of a final judgment as to one but fewer than all of the claims or parties. The Rule also provides:

> "In the absence of such determination and direction, any order or other form of decision, however designated, which adjudicates fewer than all the claims or the rights and liabilities of fewer than all the parties shall not terminate the action as to any of the claims or parties, and the order or other form of decision is subject to revision at any time before the entry of judgment adjudicating all the claims and the rights and liabilities of all the parties."

This language clearly suggests that a claim which is dismissed and is not made final under Rule 54(b), automatically survives until final judgment is entered, at which point the dismissal becomes appealable. Rule 54(b) does not require that any special procedures be followed in order to preserve an appeal from a non-final interlocutory dismissal order. No special procedures should be imposed by this Court.

DEFENDANTS' OFFER NO RATIONALE AND CITE NO AUTHORITY FROM THIS CIRCUIT WHICH SUPPORTS THE ADOPTION OF THE NINTH CIRCUIT WAIVER RULE

Besides a string citation of authority from the Ninth Circuit, defendants suggest no rationale or offer additional authority which supports the application of the waiver rule

in this case. Defendants refer to five decisions from this Circuit which they argue support the adoption of the waiver rule, but none of these cases have anything to do with the "waiver" issue raised in this case.

For example, defendants rely upon *Ericson v. Seamen*, 94 F.2d 437 (7th Cir. 1938). But that decision was based entirely on Illinois law and has nothing whatsoever to do with federal practice and procedure.[3]

Nisbet v. Van Tuyl, 224 F.2d 66 (7th Cir. 1955), also cited by defendants, did not involve a waiver issue arising out of the dismissal of a claim which was not included in a subsequent amended pleading. In *Nisbet*, the plaintiff simply elected to replace an original pleading with an amended pleading *before* any substantive rulings on any claim had occurred. The issue of waiver of a prior claim was not presented in *Nisbet* and the decision provides no support for defendants' argument.

The same is true with respect to all of the other Seventh Circuit authority cited by defendants. *See Dempsey v. Guaranty Trust*, 131 F.2d 103, 105 (7th Cir. 1942) (defs.' memo., pp. 5, 9); *Lubin v. Chicago Title & Trust Company*, 260 F.2d 411, 413 (7th Cir. 1958) (defs.' memo, p. 4); and *Buck v. New York Central Railroad*, 275 F.2d 292 (7th Cir. 1960) (defs.' memo, pp. 4, 6).

Defendants' "confusion" argument is equally groundless. Defendants contend that allowing plaintiffs to appeal from the dismissal of claims alleged in the original and amended complaint "creates confusion" as plaintiffs "alternate be-

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[3] The Ninth Circuit also relied on *Ericson* in adopting its waiver rule, but obviously this was inappropriate. *Loux v. Rhay*, 375 F.2d 55, 57 (9th Cir. 1967).

tween defending the Complaint and the Amended Complaint." (Defs.' memo, p. 8) The problem with this argument is that defendants' confusion has nothing whatsoever to do with the issue of whether plaintiffs waived their right to appeal by filing an amended complaint.

Moreover, in their brief, plaintiffs do not alternate between the original and amended complaint. Instead, they focus on a single legal issue: whether a party must allege and prove "loss causation" in order to sustain a claim for violations of Section 10(b) or a RICO claim based upon Section 10(b) violations. Plaintiffs concede that they did not allege "loss causation" in either their original or amended complaint. So neither pleading aids them if this court determines that "loss causation" is an essential element of their claims.

CONCLUSION

Defendants' urge this Court to adopt a highly restrictive procedural rule which finds no support in the Federal Rules and is generally criticized in the cases and literature. The effect of this rule, if applied in this case, would be to preclude the plaintiffs from appealing the dismissal of certain claims which they clearly intended to preserve for appeal. This result would be neither logical nor just.

The Supreme Court has said:

> Rules of practice and procedure are devised to promote the ends of justice, not to defeat them. A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly

> rules of procedure do not require sacrifice of the rules of fundamental justice.

Hormel v. Helvering, 312 U.S. 552, 557 (1941).

A similar rationale should be applied here. Defendants' motion to dismiss that portion of this appeal which concerns the dismissal of plaintiffs' Section 10(b) claims should be denied and the briefing schedule should be reinstated. Alternatively, this cause should be remanded to the district court to allow Judge Duff an opportunity to reconsider his rulings in light of this Court's recent decision in *Rankow.*

Respectfully submitted,

R. RICHARD BASTIAN, III, B. P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR. and M.T. DAVISSON

By: ______________________________
Their attorney

Michael H. Moirano
Nisen & Elliott
200 West Adams Street
Suite 2500
Chicago, Illinois 60606
(312) 346-7800